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PROBLEMS OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION [FSLIC]

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

THE PROBLEMS IN THE SAVINGS AND LOAN INDUSTRY AND THE POTENTIAL THREAT TO THE INSURANCE FUND PROTECTING S&L DEPOSITS

PART I OF IV

JANUARY 31, FEBRUARY 2, 7, AND 9, 1989

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PROBLEMS OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION [FSLIC]

PART I OF IV

TUESDAY, JANUARY 31, 1989

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Cranston, Dodd, Dixon, Sasser, Shelby, Graham, Wirth, Kerry, Bryan, Heinz, D'Amato, Gramm, Bond, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The Chairman. The committee will come to order. Let me welcome our witnesses this morning and all those in attendance.

Today the committee begins a series of hearings that will lead us to the answers that we need to find on how best to deal with the problems of the savings and loan industry, the insurance fund and all related matters. It is obvious I think from all of the dominating news flow and factual information that we're aware of that the problems are extremely serious. They have to be dealt with as quickly as they can be and solved in a way that will stand up over time—a lasting solution.

There are a couple of issues, however, that are not in question and should be mentioned at the outset. One thing that is not in question is the safety of federally insured deposits, whether in savings and loans or commercial banks. The full faith and credit of the United States stands behind every dollar of deposits at federally insured savings and loan institutions up to the $100,000 insurance limit for each depositor. President Bush made this perfectly clear in his recent press statement and I fully agree with his statement and that is clearly the view of this committee.

I think we also have to keep in mind that while we are focusing on some extreme problems, they are concentrated in a relatively small fraction of the industry. They amount to very large sums of money, but it has to be said at the same time that there are other large parts of the savings and loan industry that are in solid operating condition and certainly that is true in my home State of Michigan where the S&L's are generally very healthy.

We now have a new Congress and a new administration, and together we have to confront the FSLIC and S&L problems. We will do so. The focus of these hearings will be on passing legislation not only to resolve the problems but to put in place a structure for the future that can withstand any conceivable range of problem situations that might arise that would prevent the industry from getting back into the kind of difficulty that we see today.

There's a lot of focus on the causes of the problem and they come from a variety of directions. There is certainly a shared responsibility across a broad horizon and I think our principal purpose has to be, first of all, to examine what happened so that we can construct answers that will not repeat errors of the past but our essential focus has to be forward rather than backward.

Rather than spending a lot of time assigning exactly what percentage of the responsibility goes in one direction rather than another, I think our task has to be to come up with the best possible solution that we can, one that's straightforward that the public understands and supports, and to get it done just as quickly as is humanly possible.

Among the issues that we're going to consider are the following: what regulatory and structural changes are needed to ensure that the problems that we now face do not happen again; examining the question of the need for and the viability of a separately regulated thrift industry; how much will it cost to deal with the FSLIC problems and how that cost is to be financed; and also regulatory reform that has to be undertaken to ensure that that is done at the same time that arrangements are made to pay for the cleanup of existing problems.

Speaking as one Senator, I am not of a mind to provide any money to solve this problem until we have in place a clear plan for the regulatory changes that are needed in a comprehensive fashion so that we know that we have dealt with the underlying problems and this kind of a situation won't come back around a second time.

We had originally asked the administration to testify today. They told us that they were not yet ready and able to do so. However, Treasury Secretary Brady has committed himself to appear before this committee on February 22 in order to formally present the administration's proposals for dealing with the FSLIC/S&L situation. And we are very interested in hearing from him. Should it develop that they are ready before that time we will certainly make adjustments to hear them at the earliest moment.

Today we are going to hear from a very distinguished panel and I will introduce them at the conclusion of the remarks of my colleagues.

With that, let me yield to Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, I commend you on this, the first of 14 hearings that you have scheduled so far. This is the first of what may be viewed as the board of directors of the congressional savings and loan association.

I say this because we have been called upon to do two things. First, to save the thrift industry from mounting losses; and second, to loan the FSLIC sufficient funds to close insolvent thrifts.

In a sense, we are here to review an application for a thrift industry improvement loan. Due to the size of the problem I might say the industry is clearly going to need a jumbo mortgage.

The thrift industry's house is in obvious and serious disrepair. Its walls were battered by the harsh economic winds of high interest rates in the late 1970's. The roof was disastrously weakened when the price of oil and real estate came pouring down in the 1980's. It's been looted by vandals who went on a reckless spending spree. By all accounts, the worst damage is located in the Southwestern corner of this particular house.

The repair bills are going up and up. Each estimate we get is higher than the last. The problem simply can't be painted over. There is structural damage that must be fixed. There needs to be a new foundation with sufficient strength to withstand changing economic climates and uncertainties of the future. A security system must also be installed that sets off a loud alarm at the first sign of trouble. The roof must be made wide enough and strong enough to provide shelter for those who need a safe place to deposit their savings and there must be sufficient space to accommodate all Americans in search of a place to find an affordable mortgage for home finance.

Mr. Chairman, I want to stress that we are here to make a loan. I am not prepared—I repeat—I am not prepared to give away a multibillion toaster. We should examine closely the industry's assets, income, and net worth and require a downpayment and financing terms commensurate with the industry's ability to pay. We may need to provide an adjustable rate mortgage so that payments vary as the income of the industry improves. But we should insist on a payback that makes the taxpayers 100 percent whole.

For the past 55 years the Government has pledged its full faith and credit. The savings and loan industry should know that we are here today to act in good faith to extend to them the necessary credit. However, this credit has to be on the right terms.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Heinz.

Senator Cranston.

OPENING STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. I welcome all who are present today and I know of your interest in this mammoth problem.

I would like to suggest, Mr. Chairman, that we consider trying to speed up the schedule that has been outlined. I know we have to hear from witnesses and we have to get the best advice we can, but I am troubled by the fact that costs are running at the rate of at least $1 billion and maybe considerably more than $1 billion a month and the longer a decision at least to refund and end the hemorrhaging is achieved, we just get deeper and deeper in trouble and have a bigger and bigger bill ultimately to pay.

I gather from news reports that the President will make some sort of a statement on this subject in a formal way on February 9.

Perhaps he will not come up with a full plan there. I know our schedule has been set back by the fact that Secretary Brady did not wish to appear until February 22. We wanted to hear from him before getting going, but that can lead us to late March or perhaps early April before we come to grips with the situation. And I am just concerned about that time.

I am not suggesting we try to revise it right here and now, I think we should think about it. We have three steps I think we have to take. One is to act as swiftly as we can with reasonable consideration and as much wisdom as we can apply to end the mounting nature of the problem. Second, we have to figure out how to pay and who is to pay for whatever we do. Third, we have to take steps to prevent a repetition of all this or some future crisis.

I am not sure that we have to deal with the third part of the equation while taking the first two steps because if we seek to take all the steps necessary to prevent this from happening again it seems to me that that may take us a long time to figure all that out and we have to act as fast as we can to stop the hemorrhaging.

On the matter of whether bonds should be issued and whether the full faith and credit of the U.S. Government should be behind those bonds, it seems to me that since this is a Federal Government obligation due to the guaranteed insurance on deposits, that full faith and credit of the Government should be behind those bonds. If we don't put the full faith and credit behind the bonds, we again escalate the costs very substantially. So that's one point I think we should consider.

It is difficult or impossible to pick up a newspaper or listen to the television or radio now anywhere in the country without reading or hearing about the challenges facing the thrift industry, its regulators, we in the Congress and the administration. I am glad that you, Mr. Chairman, stated clearly that no depositor should panic or be unduly concerned and I want to reiterate that point. Deposits up to $100,000 are absolutely safe. They are federally insured and backed by the full faith and credit of the U.S. Government.

The vast majority of the thrift institutions in our country are healthy. They are serving the public in the traditional thrift business carefully and prudently. Additionally, a great many of the bad actors and poor performers in the thrift industry have been removed. Nevertheless, our job is to begin the process of dealing with refunding FSLIC and making those changes in the system necessary to make sure the problem doesn't occur all over again.

I believe the savings and loan industry has put up enough money as it can. Demanding more from it would be likely to sink the remaining institutions that are on the brink and put some that are now in good shape conceivably in very deep trouble.

There are many alternative creative suggestions that have been made. I think we generally know what the options are. At stake is future confidence in our financial system and foreign confidence in our new administration's ability and Congress' ability to handle the first crisis in this new Bush era.

I look forward to the witnesses who will appear today and in the days to come as we seek a sensible solution to a mammoth problem.

The CHAIRMAN. Let me just make one comment in response to your remarks, Senator Cranston, before yielding to Senator Pressler.

I certainly share your concern about wanting to move at the most rapid pace that we can and I am acutely sensitive to the fact that the losses are mounting. That is one of the reasons that we have cleared the decks here in the Banking Committee. We are not taking up any other issue until we have taken the FSLIC and savings and loan problem straight on through, so we have a clear, unobstructed field upon which to work.

The decision of the administration to feel that they would want to come and present their formal proposal on the 22nd, as I say—I think they felt they needed time between now and then to do this.

But I would just make one other comment and we will have to see where the opinion lies on the committee as we have a chance to talk about this. I start with the proposition that what I do not want to do is see us apply a quick solution or a partial solution or anything that sort of smacks of patching the thing up and then hoping for the best and then riding on into the future. I think as we go back and look at the history of the sequence of the events during the 1980's that time after time that's happened with respect to this problem and each time the difficulties have gotten worse, that whatever was seen as the temporary solution in fact helped contribute to a further buildup of the problem at a later time.

The one thing that I want to feel that we accomplish when we are finished here as a committee and we take a legislative answer all the way through to conclusion is that we have developed something that we have the highest degree of confidence is going to stand the test of time and I am concerned about the notion that if we just do something that deals with the money side of the problem without actually dealing with the structural changes that are needed that we may in fact lose our leverage to make those changes and find ourselves 3 or 4 years from now with a $200 billion problem or a $300 billion problem, and that's just the concern that I have going in. But I would be very interested in the views of my colleagues as we go.

Senator Pressler.

OPENING STATEMENT OF SENATOR PRESSLER

Senator PRESSLER. Thank you, Mr. Chairman.

I want to commend you on organizing this series of hearings which I think are critical at this point in our Nation's history. There are a lot of small depositors in my State who are very worried and frustrated and a lot of small S&L's and a lot of small financial institutions who wonder what is going on, will they be asked to pay for this crisis, which in part they see as resulting from fraud and mismanagement, will the small depositors of America be asked to pay for this is the question on their minds.

So as we proceed forward we have to consider all the options. I am very pleased to see this report from McKinsey and Company. I am an alumni of McKinsey and Company. I get invited to an annual dinner as a result of that. I haven't been able to attend the last few years, but I read on page 12 of your report—and I look forward to your comments—that "I do not believe that the benefits of maintaining a separate regulated thrift industry are worth the cost" and so forth.

So those are the kind of different points of view that will come before this committee and we have to sift through them. I think this is a particularly good report considering all the options, but I do thank the witnesses and the chairman. I think that the small depositors of America are listening closely to what we do.

The **Chairman**. Thank you. Senator Shelby.

OPENING STATEMENT OF SENATOR SHELBY

Senator **Shelby**. Thank you, Mr. Chairman.

Mr. Chairman, I, too, am happy that you called this hearing. It will be a series of hearings. And that this committee is finally focusing its deliberation on the thrift crisis. We are all familiar with it. We in Congress, as well as the administration and a lot of the participants in the private sector, have more than enough work cut out for us.

Mr. Chairman, I agree with Senator Cranston that we should accelerate our schedule as the crisis grows worse each day, but I'll leave that up to you and your staff.

I believe that the questions you submitted to the witnesses, Mr. Chairman, are the obvious essential questions and without the answers to these questions we cannot hope to resolve the crisis.

How big is the problem? Today's witnesses vary among themselves, with Mr. Bryan estimating $100 billion as a minimum and Professor Horvitz predicting it's in the $75 billion range. Who's right? We don't know.

We have been waiting for a signal from the administration. Well, all of us know from the proposals that the Treasury has floated so far—the one last week particularly, that of taxing depositors—it doesn't appear that they have the answer and will probably have to start all over.

I don't want to dwell on the difficulties that we face. We all know them. We are all familiar with some of the scary statistics. Cleanup costs are rising by $1 billion a month, Mr. Chairman. We know we have to resolve this as soon as possible. Our financing options are limited. The core of this debate will center on what reforms must be made in the structure of the thrift industry, what changes must be made to ensure adequate, indeed excellent regulation.

Within this debate, Mr. Chairman, we must determine the appropriate role of deposit insurance in the marketplace. Mr. Bryan points out that with the present deposit insurance system the fear of failure there is not a means of getting market discipline. He points out that uninsured financial service providers such as American Express, GE, and Ford are pillars of financial strength because exposure to failure imposes limits on the amount of risk they are willing to assume.

Mr. Chairman, I am interested in what our witnesses have to say and I look forward to the question and answer period.

The **Chairman**. Thank you, Senator Shelby.

Senator Bond.

OPENING STATEMENT OF SENATOR BOND

Senator **Bond**. Mr. Chairman, I join the chorus of thank yous and commendations for starting hearings on the FSLIC crisis. Clearly it's one of our top priorities. We are delighted that we have this ambitious schedule ahead of us and I join with you and the other members of the committee in stating the urgent necessity for this action.

There are a few general observations I would like to make as we begin this series of hearings.

First, I hope that the committee will approve both the funding to recapitalize the insurance fund and a much needed reform of the regulatory structure as a package. If we pass the funding alone, we will be sending the signal that the reforms to ensure that this never happens again are not as important. There would be the possibility that once the urgent funding bill has been passed the reform bill could slip into limbo. Those of us who watched this committee early in the 100th session of Congress deal with the difficulties of FSLIC, some of us urging that $15 billion was a minimum needed at that time, struggling for months to get only $10.8 billion, can appreciate how difficult it is to get needed reforms in this or any other industry.

I think to let the money go without ensuring that the reforms are in place would be a tremendous disservice to the taxpayers or the institutions and anyone else who might be asked to come up with the money. The structural reforms must accompany the money and I wholeheartedly agree with you and will support you, Mr. Chairman, in seeing that the two go together.

Now we have heard dozens of reform ideas, but it seems to me that the only thing which could have prevented the savings and loan problems would have been vigilant, professional, independent regulation of the industry. Lowering the $100,000 limit on insured deposits would not have prevented the crisis. Limits on brokered funds would not have prevented the crisis. The only thing that really could have made this all turn out differently would have been if the Bank Board had had sufficient numbers of well-trained examiners with the supervisory authority to enforce adequate capital standards and prudent operating practices. I think we should spend a great deal of our time and attention on making the appropriate reforms in the supervisory process.

One final area that deserves our attention is the distressingly large percentage of losses to the insurance fund caused by fraud and other criminal activities. We need to look at whether the Justice Department has sufficient resources to prosecute this kind of white collar crime. I introduced legislation in the 100th Congress which stiffened the penalties for defrauding a financial institution. I have seen the House Government Operations report which recommends a series of reforms to ensure that those who commit crimes and take advantage of a federally insured financial insurance system go to jail. I intend to pursue this issue in this Congress. I look forward to working with the members of this committee on fashioning appropriate legislation and appropriations recommendations if necessary. I am delighted that you scheduled a hearing on fraud next week and we look forward to discussing this subject in further detail then.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Bond.

We did not mention the fraud issue earlier, but in previous discussions here we have had the chance to do so and I strongly agree with what you say and I think there is the prospect of the recovery of some significant amount of money if we're aggressive in going out to find the people who misappropriated it by one means or another. But it may well involve having to put some kind of a special group together, whether within the Justice Department or wherever, to get that done.

Senator Wirth.

OPENING STATEMENT OF SENATOR WIRTH

Senator **Wirth**. Thank you very much, Mr. Chairman.

I join my colleagues in praising you for doing this. Also, I wanted to echo your themes of reviewing what happened so we don't repeat the mistakes of the past in finding out how much all of this is going to cost because that's going to be the concern of the American public has first and foremost and also the whole issue you raised and Senator Bond just spoke to of the changes that have to be made before any new commitments are set by us.

Finally, I would hope that we might spend some time looking at the theme that runs through all this and that is the theme of the size and scope of the Federal involvement in the economy through insurance programs. What we are doing, or have done in the S&L business, is in part make this risk-free. We were guaranteeing deposits and then letting the people who had those guaranteed deposits do anything they wanted to do. It seems to me that raises the issue that Senator Graham and I tried to touch on in the legislation that we introduced last year and the year before about how far the Federal Government ought to be going. I think there are some very real questions that are raised here and that that's an underlying issue that is going to pop up over and over and over again. I know you're concerned about that, as am I, and we just hope that as these hearings progress we will see that I hope come to the surface again.

Thank you very much for moving out as rapidly and carefully as we have in this set of hearings.

The **Chairman**. Thank you, Senator Wirth.

OPENING STATEMENT OF SENATOR GRAMM

Senator **Gramm**. Mr. Chairman, let me join everybody else in thanking you for holding these hearings. I think we face a very difficult problem. I can't help but remembering that 2 years ago many of the same groups that appear before us this year were also before us. Today they are saying "there's no bottom to this problem and only reaching deeply into the taxpayers' pocket can solve it." They were saying 2 years ago that it was a minor problem and any more than a $5 billion recapitalization was unnecessary and imposed too heavy a burden on the industry.

I think the cold reality is that while this is a rotten, stinking problem that nobody wants to pick up, 90 percent of the member institutions of the industry are solvent, about 60 percent are profitable, and they are the primary holder of the contingent liability on this problem. If this problem falls in anybody's lap in terms of liability of an insurance fund, it is the insurance fund of the S&L industry, and they hold the primary contingent liability on that problem.

Mr. Chairman, let me also say that while I have not gone out of my way to defend the Federal Home Loan Bank Board, I think the plain reality is that after 2 years of Congress fooling around and refusing to act, making the problem worse, imposing $1 million a day of costs on the industry, and potentially on the taxpayer, the Federal Home Loan Bank Board with no more than $10.8 billion of recap funds has done a lot to deal with this problem.

I am familiar with the problem the painful way because much of it is in my State, which is in a recession. As I listen to people talk about the problem I seldom hear any awareness of the fact that the Federal Home Loan Bank Board has dealt with about 60 percent of the problem in Texas, and that the institutions that have been created in that process are now viable institutions, at least in the current state of the economy. I believe that an economic recovery, which is underway in the Southwestern part of the country is going to help deal with this problem.

Finally, Mr. Chairman, let me say that I certainly did not rush out to embrace the so-called Brady proposal, which was I assume leaked, but I was a little bit startled at how quickly Members of Congress were to rush out and be sure that we buried it 6 feet deep. I didn't hear any awareness in that discussion of the fact that there is a big problem out there. I didn't hear anybody propose alternatives to this insurance payment by depositors, and I think the cold reality is that probably all of our insurance funds, given the potential liabilities we face, are underfunded, and that we are already paying an insurance premium. The institutions are paying it as well as the depositors in terms of higher interest rates on funds borrowed, so the depositors are paying it indirectly, or directly if they are borrowers. If I were going to gaze into a crystal ball and make a prediction, my guess is that deposit insurace premiums are going up, that somebody is going to end up having to pay them, and my guess is it will be the institutions, but the depositors will pay them indirectly. So we'll bury this proposal on one day, and we'll dig it up on another, and end up having it in some form in the solution. The reality is that there is a big cost out there. Somehow it's got to be dealt with. Mr. Chairman, I look forward to working with you and coming up with a solution. It's not going to be easy. It's going to take a real commitment on the part of this committee to come up with a solution to the problem. It is going to be very painful and very expensive and probably very unpopular by the time it's over. What we're going to have to do is to suggest to people that, if this seems bitter, then they need to suggest a less bitter way of trying to deal with the problem.

The **Chairman**. Thank you, Senator Gramm.

Senator Dodd.

OPENING STATEMENT OF SENATOR DODD

Senator Dodd. Thank you, Mr. Chairman.

Let me again join others in commending you not only for the thoroughness that these hearings will offer us and the thorough way these hearings will be conducted over the next month and a half, but also for the speed with which we are moving on this issue. Senator Gramm is correct—I don't know of anyone yet who's come up with a solution that's going to be painless on this one. It's going to be a difficult time.

I think these hearings must, as I'm sure they will, address several issues if we are to devise the most appropriate solution to the crisis. First, before we can develop a solution, we must understand how we got into this mess in the first place. We must identify the causes and assess if possible their relative contributions to this problem. Thus, I am going to be asking our witnesses today and others to try and place a percentage, if you would, on each of the causes. How much of this problem was caused by mismanagement? How much was caused by fraud? How much was caused by regulation of the 1970's? How much was caused by deregulation at the Federal level? How much was caused by deregulation by the States? How much was caused by the regulatory failures from an inadequate number of examiners from mistaken regulatory policies and how much was caused by the failure to give the FSLIC adequate resources to solve the problems earlier?

I think it's imperative that we have good answers to these questions in order to frame the best, most cost-effective solution.

Next, Mr. Chairman, I think we must get the best possible estimate of what it is really going to cost both to clean up the existing problems and to provide adequate resources to deal with future problems. For the future this will certainly mean putting Federal deposit insurance on an actuarially sound basis.

Third, we are going to have to devise a fair system of paying for the problem. It's clear this is going to involve substantial amounts of Federal dollars. Anyone who thinks otherwise is deluding themselves.

In addition, we should take as much as possible from the S&L industry without taking so much as to make the whole industry a problem, and without unfairly assessing S&L's that have behaved responsibly over the years. In that regard, I think it's important to remember that about ¾ of the S&L industry is financially sound. We must be careful not to assess them so much that we throw out the baby with the bath water by making them part of the problem by making them uncompetitive with other financial services.

Last, we must make changes in the system to prevent a recurrence. In this regard, I will be asking witnesses their views on such possible changes as separating FSLIC from the Bank Board, and establishing a system of risk-based premiums. There are also more drastic changes which we need to get the views of the various witnesses on. These would include limiting the authority of the States to grant S&L's powers beyond those authorized under Federal law, merging the two insurance funds, and even abolishing the S&L industry entirely.

I hope we will get clear answers, and I'm sure we will, from our witnesses.

Before closing, Mr. Chairman, I'd like to just focus on one specific idea. Many critics have argued that we would be better off today if the FSLIC had liquidated more S&L's rather than simply finding merger partners over the last period of time. At the same time, we all recognize that the FSLIC simply lacked the funds to do many liquidations. Moreover, despite our best intentions, it is unlikely that the Congress will have the permanent solution to this problem before the late summer or early fall. Thus, my question is whether it doesn't make some sense to deal with this problem on a two-track basis. The first track would be an immediate transfusion of dollars so that the FSLIC has the option to liquidate institutions where it would be most cost-effective. Our colleague from Alabama has accurately pointed out, as has the media, that delay cost $1 billion a month. Between now and next fall that's an additional $7 or $8 billion. If in fact the FSLIC were capable of liquidating expeditiously some of these institutions, an infusion of something like $2 billion immediately might save us $5 or $6 billion as we try to come up with an answer which is both substantively sound and politically feasible.

So I'd like today to raise that question with our witnesses for the purposes of discussion. While it's costly, it could cost us a hell of a lot more money over the next 6 or 8 months if we don't liquidate some of these institutions and do it fast and don't waste the time or kid the American public that you can somehow stretch this thing out over the next 8 or 10 months and have it cost less.

Mr. Chairman, I appreciate the opportunity to express my views.

The CHAIRMAN. Thank you, Senator Dodd.

Senator D'Amato.

Senator D'AMATO. Mr. Chairman, I'm going to ask that the full text of my remarks be included in the record as if read in its entirety.

Mr. Chairman, I think Senator Dodd has touched on something Senator Gramm has alluded to as well. You cannot just come down on FSLIC or the Federal Home Loan Bank Board and say what a terrible job they're doing if we don't give them the resources to deal with those very obvious and urgent hemorrhaging situations. They have identified a number of institutions that to allow on a daily basis is absolutely squandering of resources. We've heard $1 billion a month, but we can identify rather quickly a number of those and deal with them.

What we're doing though is bashing. We're bashing the industry. We create a situation where there is the loss of depositor confidence and we are just going to exacerbate this problem. Coming forth with some of the proposals have done little but do exactly that and I would suggest that one of the things that we can do is along the lines that Senator Dodd raised and that is to at least come up with some dollars so that those areas which are clearly identifiable and need immediate action can be attended to rather than wait for a total and complete package which in my opinion we're never going to pass without a great deal of pain and without too much time going by. There's probably going to be 6, 7 or 8 months at the best. And I recall again the railing against coming up with the $15 billion. That would have saved us money, but there's no sense going back and recapitulating that but certainly we should not err once again and fail to recognize that there are going to be, unfortunately, taxpayer dollars involved in this and the faster we step up to the plate to deal with those open wounds that are easily identifiable, the greater we exacerbate and loan ourselves to exacerbating the problem.

I thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, I am anxious to begin, and conclude, these hearings on the FSLIC deficit and the problems of the thrift industry. I am anxious to conclude because, as you know, this problem is not new to this committee. Enormous volumes of material containing information, opinion, speculation, criticism and advise on this situation have already been generated. The time has come to act.

This hearing is the true beginning of the Senate's effort to deal with this problem which many have described as a scandal. It is certainly an economic tragedy of historic proportions. As we address this problem in earnest, we must order our priorities. We must identify those things which are most important and those which, while important, are not our primary concerns. Having followed the debate on this issue for some time I am concerned at the potential for distraction. As the number of voices increases with the level of public attention, I hear too many statements that are not relevant to the central and crucial legislative issues. Therefore, let me suggest a simple statement of the congressional task on this issue.

The Congress' problem is to reestablish the integrity of the FSLIC and the FDIC at the minimum cost to the American taxpayer and the consumers of financial services. The two most important aspects of the solution to the Congress' problem are funding the FSLIC deficit and insuring that the legal and regulatory framework of the financial service network is air-tight and will avoid problems in the future. Consistent with these two priorities we should act quickly so that we avoid further losses and eliminate the terrible burden that the FSLIC deficit has placed on the remaining healthy thrifts.

Swift action is the essential ingredient in avoiding further losses. We hear that the FSLIC deficit grows by $1 billion per month. Even in the context of so large a problem $1 billion is a great deal of money. Such urgency counsels decisive action. Indeed, had we been more decisive in the past Congress, we would probably face a smaller problem today. But avoiding further unnecessary losses does not mean scuttling the thrift industry.

Since homeownership is a priority of government we would be remiss in our duty to the people we represent if our "solution" to the FSLIC deficit resulted in further damage to the industry which supports the home mortgage needs to our citizens. I am aware of the changes in the mortgage industry which have been brought about by the entry of many new types of mortgage providers and the growth of the secondary market for mortgage debt. I am also mindful of the arguments that a separate thrift industry is an anachronism. However, we must not lose sight of the fact that most of the home mortgages in America are still originated by thrifts. We must also bear in mind that the vast majority of FSLIC-insured thrifts in the vast majority of our States are good businesses that provide an essential service at a reasonable rate. Furthermore, thrifts are a tried and true source of home mortgage funds in bad times as well as in good. In any case, the future shape of the home mortgage lending industry is a relatively academic issue compared to the problems that healthy FSLIC-insured institutions face today.

The going-concern thrift today faces several threats to its profits, its reputation and its ability to attract funds at reasonable rates. The special FSLIC insurance assessment, the artificially high cost of funds, the constant barrage of a negative press and, now, new and potentially onerous regulatory capital requirements combine to create a tremendous handicap for institutions that are trying to make an honest dollar in the highly competitive home mortgage market. The thrift industry may be a big part of the problem but it must also be a significant component of the solution. Our task is insuring the availability of home mortgage funds through a safe and sound and vital financial services industry. In that light, I caution my colleagues as well as every responsible agency of government that the worst thing that can happen is the loss of depositor confidence in our savings institutions. The problem is enormous and the picture is not rosy; however, every depositor's funds are safe up to $100,000 per account and every voice should be careful to avoid even implying anything else.

We know that the solution to this problem will be very expensive—some estimates put the cost at $500 per taxpayer; recognizing the fact that people who had nothing to do with the problem will pay this huge amount of money, we must be mindful of our priorities—fix the problem; minimize cost to the taxpayer.

Other related issues are of concern to us but should be secondary. The futures of the management, shareholders, and bondholders of every thrift institution are not the Congress' problem. As sympathetic as the problems of managers and investors may be, their concerns are the problem of the institutions which got themselves—and the American taxpayers—into this mess through poor judgment, bad management and, in far too many cases, outright fraud.

In our efforts to reform the industry's regulatory structure, we must focus on the basic needs of the consumers that the thrift industry has provided: a safe place to bank their money and a source of a home mortgage loan. Congress' job is to meet these priorities and it is the industry's problem—or opportunity—to adjust, within the free market economy, to this reality. Those institutions which have grown too weak to survive will not—their depositors will be fully covered but the institutions will not be "bailed out." Indeed, if I could eliminate one term from this debate it would be "bail-out." We must avoid the distraction of talking about an industry "bail-out." The bloated and inefficient sector of the industry has already been bailed out too many times. The FSLIC recapitalization plan of 1987 was the last thrift bail-out; it assured that the FSLIC would lack the resources to close even hopelessly insolvent thrifts in sufficient volume to have an impact. The bank board's much-criticized southwest plan mergers are a direct result of congressional action; we gave the FSLIC the task to close or merge failed thrifts and gave it insufficient tools to do the job.

Now it is time to complete the task that the southwest plan began. Consequently, the industry's leadership must face the reality that they no longer offer a unique service and must compete in a larger world of financial services; the time has come to get rid of the dead wood and look to the future.

In conclusion, I will decline the opportunity to talk about the gravity of the problem. We know that. I will only caution that it can get worse unless we act resolutely and consistently. The interests of the people will be served only if we keep our eyes on our priorities—clean up the FSLIC deficit and prevent a recurrence by insuring the survival of a healthy mortgage-lending industry.

The CHAIRMAN. Thank you, Senator D'Amato. I might say that we will be hearing from the Federal Home Loan Bank Board. They are scheduled to come in shortly after the administration makes its formal proposal. But, of course, any requests they want to make of the committee or the Congress they are free to do any time along the lines of what you suggest.

So that, Senator Bryan.

OPENING REMARKS OF SENATOR BRYAN

Senator BRYAN. Mr. Chairman, I just want to join in some of the comments that have been made, particularly Senator Bond's observation that any bailout provision which ultimately evolves must it seems to me be linked with the concept of reform. I am not interested in pursuing one without the other. Justice Oliver Wendell Holmes once observed that a page of history is more instructive than a volume of logic and certainly it seems to me that we have an opportunity at this juncture as members of this committee to look at the history of how we got to this position and that history in my judgment indicates a failure in the regulatory process itself. Perhaps as Senator D'Amato and others have observed, a failure on the part of the Congress to provide the necessary resources to do the job.

It seems to me that there is an inherent conflict between the responsibilities of the board and the responsibility in terms of the FSLIC aspects of that operation and those from my perspective we need to bifurcate that function at some part of the reform process.

Thank you very much.

The CHAIRMAN. Before we continue, I have statements from Senators Dixon and Sasser to be inserted in the record at this point.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, over the last week the thrift crisis has hit the public consciousness in a way it never has before because last week the administration started talking about taxing savings. A number of administration officials, evidently forgetting their grounding in the Richard Darman "Duck" test, tried to tell the American public that charging savers 30 cents for each $100 they have on deposit at a thrift, bank, or credit union is not a tax but a user fee. However, that simply will not wash, and those officials were rather silly to even attempt to make that kind of crazy argument.

The American public knows a tax when it sees one; I can tell you flatly that my constituents know its a tax, and they don't like it. They know they didn't cause the thrift crisis, and they know what the administration seems to have forgotten—that we need to encourage people to save more, not less.

This is supposed to be a savvy administration. It is filled with people with years and years of Washington experience. And yet the first proposal they make has the effect of undermining people's confidence in our deposit insurance system, confidence that has been built up so laboriously over the last 50 years and more.

The thrift crisis is extremely serious. Fully ⅓ of the savings and loan industry is in real jeopardy, and the economic condition of another third is marginal. Ask yourself, however, how serious the crisis would be without the existence of deposit insurance. Without insurance, we would be facing a savings and loan system that had totally collapsed; without deposit insurance that collapse would probably cause our whole economy to collapse.

The administration has been faced with overwhelming opposition to its savings tax "option," but instead of taking the opportunity to try to restore the confidence in the deposit insurance system it so dangerously undermined, the administration fudges, and talks about how congressional leaks are undermining bi-partisan cooperation to solve the underlying crisis. Even worse, the administration floats a new option—increasing deposit insurance premiums that banks and S&L's pay and combining that with a somewhat lower tax on savings. That's the same thing! It is still a disincentive to save. It demonstrates that the administration has not learned its lesson from last week's controversy.

I'm the first to say that we should be trying to find a bipartisan solution to this problem, and I want to work with the administration. However, congressional opposition to the savings tax was not based on a partisan desire to score points at the administration's expense. The strong, bipartisan, congressional opposition was based on one simple fact—the idea was simply terrible and has no place in any proposed solution to the thrift crisis.

The Treasury Department knows what is needed. The problem is that they are trying to avoid the options that make the best public policy sense in order to try to sneak through the next budget year without having to reconsider the President's campaign pledge not to increase taxes.

Treasury knows that it will take between $50 and $100 billion—and perhaps even more—to resolve the thrift crisis, and Treasury knows that this money should be spent over the next three years or so. To keep faith with the no-tax campaign pledge, however, they are trying to keep the spending "off-budget," whether that makes sense or not. To try to keep that pledge, Treasury is being forced to consider departing from the basic principles that should guide a solution to this problem.

Thank you, Mr. Chairman.

STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Mr. Chairman, I am pleased to be here as the committee begins its examination of this pressing national issue. I also would like to echo the assurances given by you Mr. Chairman, and my colleagues—savings in federally insured depository institutions are perfectly safe both from insolvency and taxation.

Indeed, it is our commitment to ensure the safety of deposits, by putting the Treasury behind the insurance fund, that is the cause of the current crisis. Finding the funds to cure the insolvency will be no easy task.

But it must be done, and done soon. Although the industry bears the primary responsibility, I think it's increasingly clear that depositor safety is so important that the Government is going to have to absorb some part of the cost.

And that is not to say that the Government isn't already absorbing the cost. Mr. Chairman, I am very disturbed at the size of the tax breaks that have been awarded recently upon the sale of insolvent thrifts.

It was estimated in the popular press that just the deals that were done in December cost the taxpayers $4 billion. Mr. Chairman, if there's going to be a "taxpayer bailout" I think we should be up front about it.

There should be appropriate oversight and accounting controls. We shouldn't hide it in the form of billion dollar rebate checks to rich people that will flow out for years to come.

And we shouldn't spread the delusion that the economic recovery of certain regions or sectors can solve this problem. When the GAO goes in and finds fraud and mismanagement in every single sick institution it examines, no economic uptick is going to cure that problem—a bad loan's a bad loan.

But Mr. Chairman, it is critical that we go after fraud with everything we've got. Indeed, I think the Justice Department and the FBI have been very slow in pursuing this—to my knowledge no one has been indicted, never mind gone to jail.

Therefore, I am pleased, Mr. Chairman, that you have scheduled a hearing for later on in the month on the fraud issue. This will give us the opportunity to examine the scope of this crime as well as the Government's progress in bringing perpetrators to justice. Thank you, Mr. Chairman.

The CHAIRMAN. I want to say before introducing our witnesses that I appreciate all the comments that have been made around the table this morning. This is our first opportunity as a newly constituted committee in this Congress to actually begin to talk among ourselves in this more formal setting about our individual views, where we are on the FSLIC savings and loan problem. And I have listened with great care to what all have said and will continue to do so because obviously what we need to do is not only get all the issues out on the table and gather the expert testimony but to decide among ourselves what constitutes the best answer here. So I will continue to seek in all forums, here and otherwise, the comments and ideas of everyone on the committee. I really want us to work as a team here and I think the key to the quality of our eventual decision making will depend very importantly on the degree to which everybody is actively a part of that process and I intend to do all I can to foster that.

With that, let me now introduce what is a very distinguished panel of independent experts who have brought to us today their respective points of view and analysis of this problem. Mr. Lowell Bryan, who is the director and senior partner of McKinsey & Company. As Senator Pressler has said, they have done a major study here which they will share with us today. Mr. Andrew Carron who is director—mortgage research at the First Boston Corp. And Paul Horvitz, who is the Elkins professor of banking and finance at the University of Houston.

I will start with you, Mr. Bryan, and ask you if you will to—you all have submitted your testimony ahead of time. We are grateful for that. We have had a chance to look at it and analyze it. There are questions for you. I would like you to go ahead and make an introductory statement. If you can hold that to 10 minutes or so, and then we can move along, that would be very helpful.

STATEMENT OF LOWELL L. BRYAN, DIRECTOR AND SENIOR PARTNER, McKINSEY AND CO., NEW YORK, NY

Mr. Bryan. Thank you, Mr. Chairman. I am pleased to have the opportunity to testify before this committee and particularly pleased to hear the will expressed around the committee to deal with the problem.

As you may recall, Mr. Chairman, when I testified before this committee some 15 months ago, I estimated there could easily be a $100 billion liquidation cost to resolving the thrift crisis at that time. I still use the $100 billion estimates only it was formerly a maximum figure and now it's a minimum figure. Later on, if you want, I am prepared to explain how our research team arrived at this number.

The truth is without honest accounting no one can know how big the problem is and, as you can tell from my prepared statement, I believe the Bank Board is compounding the problem with its misconceived Southwest plan approach.

I continue to be amazed at how many people in Washington continue to underestimate the magnitude of regulatory effort and cash needed to resolve this problem. The resources that are being brought to bear are simply inadequate to deal with the magnitude of the problem. We are playing with dynamite.

In addition to the $420 billion of liabilities in savings and loans with no tangible net worth, there is another $400 billion in liabilities in severely undercapitalized S&L's. These institutions are not yet insolvent using GAAP accounting. However, with honest accounting, many of those institutions could already be insolvent. And what's more, if we were to have either interest rates go through the roof or a recession, many of these institutions could easily go well over the line. In addition, there are some $400 billion in liabilities in severely undercapitalized commercial banks. If we were to have a recession this problem could explode. Today, roughly 10 percent of the deposits in the Nation are held by institutions with no tangible net worth. If we were to have a recession that number could go to 25 percent of deposits. Despite all the public visibility of the problem most people do not understand yet that this is a dynamic not a static problem. Extrapolating $1 billion a month could underestimate the potential exponential problem this could develop into.

FUNDAMENTAL PROBLEM

Unless we fix the fundamental cause of the problem it will get far worse. Simply papering over the problem, as the Bank Board is doing, will ensure the problem gets worse. The fundamental problem is that we unleashed price competition for deposit taking in 1982 without reforming the underlying deposit insurance framework. Now we have insured depositories, not just savings and loans but commercial banks as well, assuming risks that the marketplace would never have allowed them to take if investor funds were at risk. One way of theoretically curing this problem is to put depositor funds at risk. I think the Great Depression proved this to be a bad idea.

People need to feel confident they have a safe depository and a safe payment system or they panic. Deposit insurance is now part of our social contract. I believe it is impossible for us to treat depositors as investors. In other words, you cannot use the fear of a depository institution's failure as a means of getting market discipline. Investors make risk-rewards tradeoffs. Depositors want to earn risk-free rates of return. Yet since insured depositors are allowed to bid whatever they want to obtain funds, we provide depositors with the opportunity not to just earn a risk-free return but a very high rate as well. This is a fundamental anomaly in the system. We allow the least skilled institutions, not to mention in some cases fraudulent players, to bid as much money as they want to get as much money as they want and to take whatever risks they want.

Curing this problem is what deposit insurance reform is all about. Without this reform we will continue to systemically concentrate risks in our weakest financial institutions where it will eventually be absorbed by the Federal Government. This process will continue until we reform the system or until our financial system breaks down.

If we act today, we can, with some great pain, deal with this problem. If we patch up the system or, even worse we continue to compound the problem as the Bank Board is doing, then we will wind up with a problem so massive that it will threaten our national economy and our national well-being.

It is my sincere hope the Nation will address the problem now. Thank you.

[The complete prepared statement of Mr. Bryan follows:]

TESTIMONY TO THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS ON THE SAVINGS & LOAN CRISIS

Lowell L. Bryan

January 31, 1989

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Although my testimony is based upon research undertaken by my Firm, McKinsey & Company, the opinions expressed are my own and do not necessarily represent the views of my colleagues.

Mr. Chairman, I welcome the opportunity to testify before this Committee again. I wholeheartedly agree with your point-of-view that resolution of the thrift crisis should not be delayed and must be the top priority of both the Committee and the Administration in the financial services arena.

I have organized my testimony to focus on the questions you raised in your letter to me:

1. How big is the problem?
2. What are the risks and benefits to the public of the failed thrift transactions completed by the Bank Board last year?
3. How should the cost of dealing with the problem be financed?
4. The need for and viability of, a separate regulated thrift industry?
5. What regulatory and structural changes are necessary to ensure that the problem does not recur?

HOW BIG IS THE PROBLEM?

As you may recall, when I last testified before this Committee in October of 1987, I estimated that there could easily be a $100 billion liquidation cost to resolving the thrift crisis at that time. I now believe that the $100 billion estimate of net present value eventual cost now being used by many people, including myself, is a minimum figure; the maximum figure is a larger, unknown number that is heavily dependent upon regulatory and legislative actions. While the Bank Board tries to label such estimates as "absurd," let me remind the Committee that only last May the Bank Board estimated that the net present value cost of resolution of the thrift crisis was only $22.7 billion. Even now some Washington observers cling to the hope that the issue is being overblown. Surely, it is not a $100 billion problem.

Unfortunately, the problem is at least that bad. Our McKinsey research team has used several estimating methodologies (e.g., estimated liquidation cost, excess of liabilities over earning assets, projection of FSLIC's cost of resolution to the entire universe of insolvent institutions, capitalized cash flows, etc.) and they all yield a shortfall of at least $100 billion.

Some numbers would be helpful to bring home the magnitude of the problem. First of all, it is important to note that the savings and loan industry is really divided into two very different segments (Exhibit 1). One part of the industry, with some $850 billion in assets, is reasonably healthy in terms of capital and earnings capacity (although in truth, about half of these institutions are severely undercapitalized). The other part of the industry, which includes savings and loans which are either insolvent or which have only a negligible tangible net worth is very troubled. These institutions had some $424 billion in liabilities and a combined net worth of negative $21 billion as of June 30 of last year (the last time period before reported industry numbers were distorted by the impact of "Southwest Plan" transactions). At that time, these institutions were paying out about $30 billion a year in interest, and $8 billion in expenses to keep the doors open. Unfortunately, these same institutions were only booking interest income and other income of about $32 billion. That is, these insolvent thrifts were showing some $6 billion a year in operating losses, which they continue to fund by raising still more deposits. But these accounting operating losses are only part of the problem. Our McKinsey research team believes the real operating loss problem is worse than these accounting numbers would indicate.

The liabilities of these unhealthy savings and loans through June of last year were growing far more rapidly than the liabilities of the healthy institutions (Exhibit 2) and now exceed by at least $100 billion the value of assets. In 1986, the liabilities of the unhealthy thrifts were 41 percent the size of the liabilities of the healthy thrifts. By the second quarter of 1988, the liabilities of the unhealthy thrifts were 51 percent the size of the healthy institutions' liabilities.

We believe the sources of this growth up until last June were two-fold. First of all, we believe many of these institutions, particularly those that were still technically solvent if intangible assets are included as capital, were adding deposits and were taking on even more risk in a desperate attempt to restore earnings and maintain solvency. On an even darker note, we believe some of the deposit growth of the unhealthy thrifts has been due to the sheer amount of cash that these institutions have had to raise to meet their cash shortfall from operations. Part of this cash shortfall is transparent (i.e., the reported $6 billion in accounting operating losses mentioned earlier). However, we believe the real cash shortfall could be as much as $10 to $15 billion a year. The capitalized value of negative $15 billion annual cash flow implies a negative net present value of well over the $100 billion number used earlier. We believe the magnitude of the real cash shortfall is being disguised through the misuse of Generally Accepted Accounting Principles, particularly the continued accruing of interest for construction loans on commercial properties and condominium projects where the market value of the property is far below the loan amounts outstanding.

Let me explain with an example. General Accepted Accounting Principles allows lenders to lend to borrowers the interest to be paid on construction loans. This is fine provided that the construction loan is converted to a permanent mortgage which is paid off through mortgage or rent payments made by the building's occupants. However, during the 1980s insolvent institutions have abused these principles to keep "current" loans that are in fact "non-performing." Specifically, loan agreements were written in the early 1980s which have included two or three years of interest payments as well as money for leasehold improvements (i.e., improvements demanded by tenants in order to rent the properties) (Exhibit 3). Many of the buildings for which such loans were granted have now been completed for years, but no tenants have been found. While these practices have delayed defaults, eventual default is now inevitable because the loan amount far exceeds market value of the building. Eventually all such loans will move from the "current" to the "non-accruing" column. What is worse is that, to buy time, the insolvent thrifts have continued to raise even more deposits. Anyone who understands these lending practices can see the results from miles away. Liabilities (i.e., deposits) will rise much faster than earning assets since the cash needed to pay interest to depositors, to pay operating expenses, and to keep loans current will continue to pour out of the institutions while real interest income from true earning assets will fall far short of the cash needed.

There is a further problem as well. The severe overcapacity of empty buildings in many markets is beginning to have a dramatic effect on the value of otherwise sound projects (Exhibit 4). For example, many buildings were leased up for 5 year periods. Many of these leases are now running out but the market rent has dropped by 50 percent or more and the tenants are now able to negotiate much lower leases. This, of course, lowers the cash flow from the project to below the level required to service the debt. Simultaneously, the market value of the property is severely reduced.

We therefore believe that the underlying problem is a cash flow problem. The underlying mortgages are insufficiently supported by cash flows from occupants of the buildings. In turn, this means that the insolvent thrifts have inadequate cash flow from earning assets to cover their cash outflows.

With this perspective it is easy to see why the situation has been deteriorating so rapidly. The real underlying cash flow problem has been being masked by misleading accounting. While the real problem has been building over years, the accounting of the magnitude of the problem only began to catch up with the cash flow reality over the last 18 months. This is why most observers, including the Bank Board itself, were caught by surprise at the speed of the deterioration reported results last year. What was growing so rapidly was not the underlying problem, but rather the accounting recognition of the problem.

By the third quarter of last year this reported deterioration of the condition of the industry apparently began to be reversed. Unfortunately, this reversal was not due to any fundamental reversal of the cash flow problem outlined earlier. Rather, it reflected the results of the "Southwest Plan" which enabled the underlying cash flow problem for those affected institutions to again be disguised behind the combination of FSLIC asset guarantees, yield maintenance agreements, and promissory notes which miraculously enabled all of these underperforming loans to be marked up to book value. Of course, the underlying cash flow problem did not go away; it was simply transferred to FSLIC.

The terrifying aspect of this problem, for a committee concerned with understanding the dimensions of this crisis, is that all of the cash flow needed to sustain the operation of these institutions will continue to come from raising still more deposits. This means that the full extent of the eventual cost of the guarantees will not be known until the guarantees are actually honored in the future.

There are a variety of actions that need to be taken to address the thrift crisis. I believe, however, that one of the most essential actions is to make the accounting of results for all the insolvent institutions and all nearly insolvent institutions, including all of the Southwest Plan thrifts, reflect cash flow reality (i.e., marked-to-market accounting). The misuse of on-going concern generally accepted accounting principles by these institutions and their regulator must be stopped. A full detailed inventory of each institution's marked-to-market asset values, underlying rent rolls, and cash flows is essential. The American public has a right to know the full magnitude of the problem.

BENEFITS AND RISKS OF THE SOUTHWEST PLAN

I believe the Bank Board's "Southwest Plan" cashless restructurings of insolvent institutions is fundamentally misconceived. The term "Southwest Plan" is itself a misnomer. In practice, the Bank Board has applied this plan widely to thrift restructurings all around the country.

I would like to divide my comments about these restructurings into two categories:

1. Impact on the cost of resolution of the thrift crisis to the government

2. Impact on the cost to the broader public interest.

Impact on Cost of Resolution

If you believe, like I do, that the government will have to eventually pay for the costs of cleaning up the thrift mess, then one of the major problems with these transactions is that they will cost the government more than liquidating the institutions if tax effects are included. We came to this conclusion after analyzing some "Southwest Plan" transactions announced by FSLIC from August to October of last year in some detail. Just these 64 transactions amounted to $63 billion in liabilities (Exhibit 5). Essentially, this plan has FSLIC and the Federal Home Loan Bank Board using a combination of promissory notes, asset guarantees, yield maintenance agreements, and tax shields to absorb all of the risks, and most of the operating losses, of the insolvent institutions which are "rescued." Unfortunately, very few of these institutions have the franchise value they need to ever become self-sufficient, and our analysis shows that keeping such institutions alive will cost the Federal Government as a whole some 30 to 40 percent more, in net present value terms, than outright liquidation (much of this represents lost tax revenues). In other words, we estimate that the liquidation costs of the 63 "Southwest plan" thrifts (excluding American Savings and Loan) would have been about $15 billion, but that the "Southwest plan" approach will raise the net present value cost of the rescue of these thrifts to over $27 billion, assuming no worsening in asset quality and no increase in interest rates. Under less favorable circumstances (i.e., a rise in interest rates or further asset deterioration) the net present value cost could almost double to over $30 billion (Exhibit 6). These numbers are only very rough estimates, given the difficulty of obtaining accurate information about these transactions from FSLIC, the uncertainty over the amount of taxes foregone from these transactions and the ultimate cost of FSLIC asset guarantees and yield maintenance agreement.

Not surprisingly, the Bank Board disagrees with these numbers. Some of the differences between our McKinsey team's numbers and the Bank Board's numbers are due to our inclusion of an estimate of the cost to the Treasury of the tax breaks inherent in these deals while their numbers exclude most tax effects. The tax breaks are massive. For transactions completed before December 31 of last year, the tax breaks included: (1) tax-free interest on promissory notes and yield maintenance agreements; (2) the ability to write down overvalued real estate assets; and (3) the historic net operating loss carry forwards. Essentially, these tax breaks mean that companies with taxable income who acquire these institutions can significantly reduce their current taxes and that any income generated by these institutions going forward will not be subject to taxation. Our belief is that from the point-of-view of the budget, losses of taxes should be included in addition to FSLIC outlays as a cost to the government.

Further, the Bank Board uses a higher discount rate than we did for present valuing of the cost of its asset guarantees, yield maintenance agreements, and promissory notes. We used the Treasury's average cost of funds while the Bank Board used the cost of its most expensive funds. The use of a higher discount rate reduces the net present value of future obligations. We believe the lowest cost source of funding of the resolution of the thrift crisis is Treasury debt, not FSLIC debt, and that therefore, the Treasury discount rate is the most appropriate discount rate to be used for net present value calculations. In total, we therefore believe the "Southwest Plan" increases the eventual cost to the government by at least 30 percent. While the government probably has to legally honor the commitments made to the private parties to these transactions, care should be taken to curtail the risk taking abilities of these institutions so that they do not have to be rescued again.

We believe that if the government wants to minimize its costs of resolving this crisis, it should shift to a policy of liquidating the remaining hopelessly insolvent thrifts - rather than continuing to use promissory notes, asset guarantees, yield maintenance agreements and tax breaks to perpetuate the existence of institutions with no real value to the customers they serve.

One concern about this approach is how to keep the forced sale of real estate assets from further depressing real estate values (e.g., in Dallas). This might be done by allowing healthy financial institutions with strong workout skills to bid for the right to work out the assets using incentive clauses (e.g., 20 percent of the recovered value).

The Bank Board scoffs at the idea of massive liquidation of insolvent thrifts. It argues that the costs of liquidation are enormous since, upfront, all of the depositors have to be paid off. In other words, if an institution has $1 billion in real asset values and $2 billion in liabilities, the $2 billion must be committed immediately, while recovery of the $1 billion in asset values will take time. Thus, liquidation maximizes the short term cash out flow but minimizes the long term cash flow while the Southwest Plan does just the opposite. An overwhelming advantage of liquidation, however, is that the ultimate maximum costs are known, while under the Southwest Plan approach, the ultimate costs are unknown since all downside risks are absorbed by the government and the incentives to take massive upside risks remain.

Of course, the Bank Board and FSLIC do not presently have the cash needed to liquidate all the remaining hopelessly insolvent institutions. I believe some $25 to $35 billion a year in cash would be required for each of the next 3 or 4 years to accomplish the task. This would mean that well over $100 billion will be needed to liquidate all those thrifts that should be shut down. Some of this cash would be needed to honor asset guarantees to the Southwest Plan thrifts. The amount needed might be reduced through

asset recoveries and intelligent loan workouts. Against this need, FSLIC has almost no cash at its disposal. This needs to be remedied; the needed cash must be found.

Finally, the Bank Board and FSLIC are properly concerned about the sheer regulatory labor requirements of any massive liquidation effort. Liquidations are far more regulatory labor-intensive than the "Southwest Plan" approach. Liquidations involve extensive interactions and negotiations with holders of non-insured liabilities and borrowers. It entails massive work to dispose of assets (e.g., branches), to resolve legal issues, to terminate employees, and so forth. It is safe to say that the liquidation effort required would far exceed anything ever attempted before. On the other hand, we have never had such a massive need for liquidation. Frankly, I think that, over the last several years, the nation has seriously underestimated the magnitude of regulatory effort and cash needed to resolve this problem. I think that the time has come to address the problem by bringing to bear whatever resources are required.

I would like to make it clear that I am not arguing that all insolvent depository institutions should be liquidated. Some institutions, like American Savings and Loan clearly have some franchise value and should be sold off since such an approach reduces the resolution costs to the government. The critical elements to understanding whether or not there is any franchise value is whether bidders, after examining the assets of the institution, are willing to make a bid that lowers the maximum cost to the government (including the cost of lost taxes) from completing the transaction below the costs of liquidation. But to do this approach properly requires that bidders would need to cap how much risk the government is to assume and to require investors to invest real capital (as opposed to guaranteed tax savings) which is exposed to this excess risk. It is possible to do this for institutions with franchise value. For example, the FDIC capped its exposure in the NCNB-First Republic transaction.

The approach I am advocating is very different than the one the Bank Board takes today. FSLIC today compares liquidation costs, against a model estimate of the cost of keeping an institution alive through assistance. They assume the model reflects economic reality. However, since all the downside risks are fully assumed by FSLIC, this approach will systematically understate the eventual costs (i.e., if assumptions are evenly divided between those that are too optimistic and those that are too pessimistic). FSLIC will absorb all the costs of overly-optimistic assumptions and receive little relative benefit from overly-pessimistic assumptions. In other words, in order to properly compare the costs of liquidation, which are known with some degree of certainty, it is necessary to be able to determine the maximum costs to the government of the alternative (including determining the full costs of any tax breaks).

Thus, the fundamental flaw in FSLIC's approach of comparing the costs of liquidation, which are known to a reasonable degree of certainty, against the costs of a cashless restructuring based upon guarantees, is that FSLIC cannot possibly understand the maximum costs to the government of the cashless alternative. In the Southwest Plan cases, FSLIC's potential losses are unlimited while the bidders take no real risk at all.

The truth is, if FSLIC had have insisted that bidders take any real risk, it is highly doubtful that many of the Southwest Plan thrifts (except, perhaps, American Savings & Loan) would have attracted bidders since no one would have been willing to expose significant amounts of real capital to the risks of running these institutions. In practice, almost all of the supposed capital provided by the investors in these transactions was recovered immediately from tax benefits.

Impact On The Cost To The Broader Public Interest

There are other fundamental problems with the Southwest Plan. The Southwest Plan approach is also fundamentally flawed because: (1) it is socially unfair since it got the government in the business of making rich men richer; (2) it is competitively unfair since it disadvantages all solvent institutions; (3) it makes the eventual solution more difficult.

1. The Southwest Plan is socially unfair because it provided already rich entrepreneurs and financiers with a largely risk-free opportunity to become richer. Since these deals were tax based, they were open primarily to individuals and companies who had significant amounts of taxable income. With FSLIC absorbing all the risk in the transactions, these deals guaranteed the involved parties with a guaranteed return plus the opportunity for all upside profits. It is no wonder that the richest, smartest, most aggressive deal-doers in the country went after these deals. It was also advantageous for the lawyers, tax advisors and consultants who were involved. FSLIC, as you know, even guaranteed the legal fees for any challenge to these deals. I believe that to the average American, the single most bothersome characteristic of these transactions is this social unfairness. It is almost as if the government were playing Robin Hood in reverse.

2. It is competitively unfair. This approach has essentially created a new class of essentially tax-free institutions. The new class has therefore enormous advantages in bidding for assets since for these institutions pre-tax and after-tax income are effectively the same. If these institutions compete in lending, they do not have to worry about paying taxes on their lending spreads. If these institutions want to acquire another institution, they can afford to pay more since they can use their tax losses more effectively. My guess is that investment bankers will be beating a path to these institutions' doors. If these institutions take big risks and win, the owners become even richer. If these institutions take big risks and lose, the owners will simply hand the institution back to FSLIC (after having pocketed their tax breaks). However, I believe the guarantees and tax benefits provided the Southwest Plan thrifts are so massive that these institutions should be able to outperform many of the unsubsidized players. My guess is that the institutions which feel this competitive pressure the greatest will be the thousands of struggling, but still solvent, small thrifts and commercial banks which still have some capital and still pay taxes. In fact, it is those very institutions that this new class of institutions are most likely to acquire.

3. It makes the eventual solution more difficult. FSLIC's cashless restructuring approach does nothing to address the fundamental problem of overcapacity plaguing the industry. In fact, it compounds the problem by keeping in the game [illegible] losers (it actually advantages them). If these hopelessly insolvent institutions were liquidated, their deposits would have to go elsewhere. Liquidation of the insolvent institutions would reduce the overbidding for deposits, thus helping the sick, but not yet dead, institutions recover. Therefore, I sincerely believe that if we perpetuate the "Southwest Plan" approach, we will find more and more thrifts and commercial banks will slide over the line into solvency. Remember that in addition to the $420 billion of liabilities in the hands of institutions that have no tangible net worth, there is over $500 billion in deposits in the hands of undercapitalized commercial banks and thrifts.

   The "Southwest Plan" approach is also inconsistent with the market philosophy behind the de-regulation movement. Winners should win; losers should disappear.

   Furthermore, this approach is now creating a new interest group of rich, powerful individuals who will fight to protect the sweetheart deals they have struck. Given their influence, they may complicate the politics of properly resolving this crisis.

   Finally, the "Southwest Plan" approach represents a further slide down the path of confusing Alice-in-Wonderland accounting numbers for economic reality. I believe down that path lies disaster; it would be ironic to see our government perpetuating accounting fictions while nations such as the Soviet Union are discovering the virtues of honest numbers.

FINANCING THESE ACTIONS

The essential debate on financing the cost of the clean-up is whether the burden should fall on the private sector or the public sector. Like lawyers in a product liability suit, the representatives of each side are working hard to place the blame, and the assessment for damages, on the other.

Ideally, of course, we should assess the party that both is responsible for the problem and has the ability to pay the damages. Unfortunately, no such party appears to exist. How close, then, can we come?

Nobody in the private sector seems to be a realistic choice. Looking first at the most culpable parties, we see that they are not going to be any help. The incompetent, or even criminal, managers who recklessly lent out federally insured deposits have inconsequential personal assets. While prosecuting those individuals who violated laws may bring some measure of satisfaction to the nation, it will not bring in any real money.

What about taxing the healthy thrifts to pay for the problem? This doesn't seem to be a good answer, either. First of all, it's not their fault. While their industry associations may have some responsibility, the individual institutions were often outspoken critics of the unhealthy thrift practices. As has been said before, we did not ask Ford to bail out Chrysler, nor Boeing to bail out Lockheed. Moreover, the healthy thrifts are already paying a special assessment of $1 billion a year, against $7 billion of net profit. Any further assessment would begin to cripple their competitiveness and reduce their ability to attract the capital they need to serve their customers. For the marginally healthy thrifts, further taxation may be enough to tip them over the edge. Moreover, the healthy parts of the thrift industry simply do not have deep enough pockets to foot any significant part of the bill. Given what I have already said about the Southwest Plan, it would add insult to injury to ask the healthy thrifts to bear the burden of paying for the asset guarantees and yield maintenance agreements for their competition.

Well if not thrifts, what about taxing commercial banks? But the commercial banks clearly are not responsible for the thrift crisis, either. They are properly outraged at any suggestion that they pay the bill. In fact, they have been bitter critics of the practices of the unhealthy thrifts and their regulators for years. Indeed, they rightly view themselves more as victims than as culpable parties. They have had to suffer by competing against the unsound lending practices of the poorly managed thrifts and by paying more for deposits due to rate competition from insolvent thrifts. Moreover, the banks have their own credit and capital adequacy problems. It makes no sense to tax these institutions when they are in a desperate struggle to remain competitive against non-bank and foreign bank competition. If we do it, we'll probably have a much bigger failed-bank problem on our hands in a few years than we do now.

Some people have suggested another possible source of funds - the private companies and individuals who borrow from, or deposit money in, banks and thrifts. They think that a "user tax," like the one on gas, might raise the money with less pain. This might work if banks and thrifts were the only place to go to borrow money, but they aren't. In fact, it was the move to alternative sources of funds, such as money market mutual funds that helped get us into this mess in the first place. As things are now, users wouldn't pay this tax - the banks and thrifts would. For example, if we had the user tax on new mortgages that has been suggested, the institutions granting the mortgages would have to pay the tax themselves, to defend their business against un-taxed competitors. The effects on healthy institutions of this indirect tax would be just as harmful as the effects of a direct tax. Besides, users are even less culpable than healthy institutions. Future borrowers are certainly not to blame for bad loans in the past, and past borrowers are certainly not to blame for banks' and thrifts' bad credit decisions.

This leaves us looking at the public sector - that is, the federal government. Now we begin to find both culpability and ability to pay, to some degree. Most independent observers agree that the real cause of the thrift crisis has been bad regulatory oversight and the unwillingness of Congress (particularly the House) to address the problem when it became obvious some 3 years ago, that we were headed toward a thrift crisis.

Let's assume for the moment that $100 billion is the amount of cash that will be required to resolve the problem. As I have already testified, I believe $100 billion is a low estimate. One hundred billion dollars is a lot of money, even for the federal government. If $100 billion in bonds were raised to fund the costs of liquidating the worst thrifts, it would take $15.5 billion a year for 10 years, or $10.8 billion a year for 20 years, to pay interest on the bonds (assuming the bonds were raised at the current 10-year Treasury Bond rate) and to redeem them.

I honestly believe that the best approach would be to raise this money in Treasury bond form to provide the money needed to liquidate the insolvent institutions and to honor FSLIC's Southwest Plan guarantees. I would also exempt the principal amounts raised in this manner from the provisions of the Gramm-Rudman act. I would, however, include the annual amortization of the principal and the interest paid on the bonds in each annual budget. This funding approach recognizes that this problem was not created in a single year nor will it be resolved in a single year. It would therefore be misleading to have the $100 billion hit the budget over a short period of time.

I realize other people are going to argue for a variety of more esoteric off-budget financing mechanisms. Frankly, though, I think that the American public is tired of this issue and would like to see this problem resolved. I also believe the public is tired of budgetary gamesmanship and accounting gimickry. I believe we need to address the problem in an honest, straightforward manner.

NEED FOR A SEPARATE THRIFT INDUSTRY

None of us would argue with the premise that housing and home ownership is a high national priority. This issue, though, is whether you need a separately regulated thrift industry to further the pursuit of that priority.

I personally believe the answer is clear. I do not believe that the benefits of maintaining a separate, regulated thrift industry are worth the costs. Given the development of a highly liquid secondary mortgage market, given the broad expansion of commercial banks into mortgage finance, and given the broad national infrastructure (e.g., Freddie Mac, GNMA, Fannie Mae) to support housing finance, I believe that mortgage finance is generally available to any creditworthy borrower in the nation.

This is in stark contrast to the conditions that prevailed when the savings and loan industry regulatory structure was created. At that time, commercial banks were unwilling to take either the credit or interest rates inherent in fixed rate mortgages and the creation of the savings and loan industry provided the means of providing the needed housing finance.

However, the days when mortgage finance was constrained by the lack of available funds are long over. In fact, the evidence is that we now have a glut of real estate finance capacity partly due to having a separate industry, with unlimited access to government insured deposits, who see real estate finance as their primary mission. Since availability of finance has long been the only constraint on builders and developers, it is not surprising that the removal of that constraint, with the passage of the Garn St. Germain Act and the resulted expansion of real estate lending by the savings and loan industry, led to the overbuilding of commercial and residential real estate (particularly in condominium form) that we see today. This overbuilding is evident not just in the Southwest, but increasingly in the Southeast and Northeast, as well. In fact, I believe we have built substantially more residential and commercial real estate capacity than the national economy is willing to pay for and that it will take us years to work off that overcapacity.

In such an environment, I see little benefits in keeping a separate industry devoted to the housing industry. Rather, I see enormous risks.

I personally believe that there remains no useful distinction between the savings and loan and commercial banking industries. Commercial banks have become very committed to the housing and real estate industries: indeed real estate loans now exceed commercial and industrial loans as the largest category of loans on commercial bank balance sheets. Meanwhile, savings and loans have used their expanded powers to look more and more like banks. And the securitization of mortgages has dramatically expanded the role of non-depository institutions (e.g., pension funds, insurance companies, individuals, etc.) in the finance of residential mortgages. Moreover, I feel that the nation suffers by having two overlapping sets of deposit insurance regulation. Essentially, we have two sets of players, both of them are funded by federally insured deposits, which play by different sets of rules. Even the accounting used to report results is radically different. This makes no sense.

Finally, we have never had agencies fail so dramatically to do their job as FSLIC and the Bank Board. I think the time has come to eliminate the separate regulation of the savings and loan industry. While many regulators at FSLIC and the Bank Board have done their best, the net result has been a failure to protect the public interest.

I therefore believe we need an immediate administrative merger between the FDIC and FSLIC whereby FDIC regulation is applied to both funds. Then, under this approach, all the strong, healthy thrifts (probably about 40 percent of the industry) which met FDIC standards would immediately join the FDIC fund.

The remaining savings and loans would remain in FSLIC. All the hopelessly insolvent would be liquidated. The savings and loans failing to meet FDIC standards (included all of the Southwest Plan thrifts) would be given 5 years to meet FDIC standards. During this 5-year period, the risk taking ability of institutions continuing to be insured by FSLIC would be sharply narrowed. The combination of this extreme narrowing of risk taking capacity and higher insurance premiums would put great pressure on these institutions to meet FDIC standards and transfer to the FDIC as soon as possible. Many would probably seek merger partners who would recapitalize them. At the end of 5 years, FSLIC insurance would be terminated. Institutions which were unable to meet FDIC standards at that time would be subject to forced sale to an institution who would commit to recapitalising them to FDIC standards. In cases where no such buyers could be found, the institution would be liquidated. At the end of the 5-year period, we would then know the full costs of today's savings and loan crisis.

One of the principal advantages of this approach is that it keeps separate all of the costs of poor regulation of the savings and loan industry, which should be borne by the government, from the costs of true insurance, which should be borne by the insured parties. A second advantage is that at the end of 5 years, there would only be one insurance fund with one set of rules and standards.

ENSURING THE PROBLEM DOES NOT RECUR

I think that the final step in the process should be to reform the deposit insurance system so that this problem does not recur in the future. To do this we must fix the fundamental problem. The fundamental problem is that the government has been absorbing risk that should be borne by the marketplace.

Before proceeding to explain how that problem might best be approached, let me make clear that the solution I offer is not uniquely my own. It parallels, in many regards, and indeed also draws upon, the thinking of officials from the FDIC, the Federal Reserve Bank of New York, the GAO, and such scholars as Bob Litan of the Brookings Institution. I make this point, not only out of fairness to them, but also to suggest that several important thinkers are beginning to come to the same conclusions about a solution. Let me now explain.

I believe that the fear of losing one's money causes people to weigh carefully risk/return tradeoffs. The evidence that this belief is true is very powerful. Where that fear exists, we have strong financial institutions. I think it is remarkable that there have been almost no major insolvencies among that part of the financial services industry disciplined by the marketplace. American Express, General Electric Credit, Ford Motor Credit, IBM Credit are all pillars of financial strength. Not a single money market fund has had even the whisper of a problem. Of over 1,000 mortgage backed securities transactions, only one has got into trouble.

On the other hand, insured depositories, including not just savings and loans but commercial banks as well, have been assuming risks that the marketplace would never have allowed them to take if investors' funds had been at risk. The problem, of course, is that people need a safe depository and a safe payment system - deposit insurance is now part of our social contract. I believe it is therefore inappropriate to treat depositors as investors. In other words, you cannot use the fear of depository institutions' failure as a means of getting market discipline. Investors make risk/reward tradeoffs; depositors want to earn risk-free rates of return. Yet, since insured depositories are allowed to bid whatever they want to obtain funds we provide depositors with the opportunity not just to earn a risk-free return, but a very high rate, as well. This is the fundamental anomaly in the system. We allow the least skilled financial institutions to raise as much money as they want and to take whatever risks they want. Curing this problem is what deposit insurance reform is all about.

Under the approach I am recommending, the FDIC would become the sole federal insurance depository in the nation. This raises the question of how safe is the FDIC?

The answer is that the FDIC is very strong relative to FSLIC but is less strong than it should be. The commercial banking industry has written off over $60 billion in loans in the last 4 years (not including provisioning for LDC debt). In comparison, over a 30-year period, from 1948 to 1981, the commercial banks charged-off a total of only $28 billion. Based upon past history, we know that if we have a recession, loan write-offs in banks would double and would persist at that higher level for at least 2 years. We also know, based upon history, that over half of these charge-offs would be concentrated in less than 20 percent of the industry. This means that if we were to have a recession this year, it is highly likely that some 20 percent of the commercial banks would become insolvent and that the FDIC's insurance fund would be exhausted by 1992. It is for this reason why it would be penny wise, but pound foolish, to expect commercial banks or healthy commercial banks or healthy thrifts to pay for the costs of resolving the insolvent thrift crisis. They need the money to protect their depositors and to protect themselves.

But beyond this, the implications of the vulnerability of the FDIC I just cited is that without deposit insurance reform, there can be no assurance that we will not have another crisis in a few years.

What then should we do?

When I testified before you 15 months ago, I stated that I thought that when we had to come up with $100 billion out of the taxpayers' money, that there would be a backlash affect that would cause a movement to risk-free depositories. Over the intervening time period, I have become convinced that the risk-free depository as outlined either by myself in my book, Breaking Up The Bank, or by Bob Litan in his book, What Should Banks Do? is too radical a solution for the nation to accept. It would simply cause too much disruption to the banking system and probably to the economy, as well. Since I believe it does little good to tilt at windmills, I think we need a more practical proposal.

However, I believe the principal idea behind the concept is still valid. I think it is essential to make depositors make the choice between whether they are depositors or investors. In other words, an investor should expect his or her funds to be at risk but should get higher returns. A depositor should expect the deposits should be safe, but should expect lower returns than if they put their money elsewhere.

How then do you accomplish this? I believe the answer is to have the FDIC act as a true insurance fund charging whatever premiums are needed to protect its integrity, and the value of its deposits, without government subsidy. To keep these premiums in line, the FDIC would, in combination with the OCC and state bank examiners, ensure that the capital of each institution was always sufficient to cover credit and interest rate risk losses if its assets were held to maturity. In other words, depositors could always be paid off without exposing the depository insurance agency to loss. This implies either tighter standards or higher capital requirements than exist today or else First Republic and Continental Illinois would not have caused losses to the FDIC. Since capital requirements are already clearly too high for the loss experience of well-run depositories, I believe the answer is to set tighter lending standards. For example, I do not believe it makes sense to allow insured depositories to make speculative construction loans at 100 percent of appraised value.

I believe loan standards should be established for all of the assets held by insured depositories (e.g., residential mortgages, credit card loans, automobile loans, small business loans, etc.). I do not believe the FDIC should set these standards in a vacuum. Instead, it needs to rely upon a credit standards board, perhaps overseen by the OCC, and made up of some of the best lenders in the country to recommend appropriate loan standards for each kind of asset allowed to be booked in an insured depository. The members of the board would be drawn from well-run commercial banks and thrifts and from other private sector source. For example, such a board might recommend that construction loans made by an insured depository require personal guarantees from the builder, at least 80 percent of the space pre-leased, a permanent take out, mortgage loan, and a loan to value ratio of no more than 75 percent. The final approval for standards would, though, have to rest with the insurance fund since the insurance fund would be ultimately charged with protecting the public's interest. These standards would, of course, only apply to new lending. Existing loans and loan commitments would need to be grandfathered.

The FDIC could also limit interest rate risk taking and set regulatory accounting standards (e.g., ensuring strict standards for the accrual of interest on loans and for writing down assets). The FDIC would itself be subject to audit by the GAO to ensure that it was sound. The FDIC would, of course, need to have the examiners, liquidators, and enforcement powers required to make its standards stick.

By running the FDIC in a conservative manner, it would protect prudent banks from having to pay excessive premiums or maintain too much capital because "dumb competitors" were taking excessive risks with insured deposits. The FDIC would be, under this concept, a public monopoly for federally insured depositor funds but should not have any role in regulating how holding companies raise or use non-insured funds.

The question is, how would financial institutions finance assets that do not qualify to be funded with federally insured deposits? The vehicle for doing this would be a financial holding concept, which, in fact, is the quid pro quo necessary to make the conservatively insured depository concept just described workable. In fact, I believe it would be a major mistake to undertake deposit insurance reform without also moving to a financial holding company concept. Under the financial holding company concept, a holding company could own both federally insured and non-insured subsidiaries. The holding company (and its non-insured subsidiaries) would raise money from investors in the marketplace based upon its capital, its earnings strength, and the quality of its balance sheet. Firewalls would be used to keep risks taken by a financial holding company or its subsidiaries from affecting the soundness of its insured depository.

This approach would reintroduce market discipline to limit unwise risk taking. Risk taking that did not qualify for FDIC-insured depositories would have to be financed through funds provided by investors to subsidiaries of the financial holding company. Investors would, of course, demand higher rates for their uninsured investments - but market prices for financing higher risk activities would also rise, since "dumb" risk taking capacity would be eliminated through the more conservatively administered FDIC. Margins would depend on the ability of the institution to add value to each customer. Intelligent investors would only provide funds to institutions who were sufficiently skilled and sufficiently well-capitalized, to avoid exposure to loss.

An important refinement to this basic concept is to also allow a financial holding company to own a money market bank. A money market bank would be a nationally chartered institution designed to operate and compete effectively in the world's foreign exchange, money and interbank markets. A money market bank would have a liquidity line from the Federal Reserve. Such a line is essential to avoid making U.S. banks engaged in global markets uncompetitive. However, the liabilities of the money market bank would not be insured. Rather, most of its assets would be marked-to-market daily. It would be allowed to hold non-marked-to-market assets, but these assets would be limited to no more than a low multiple (e.g., three or four times) the capital of the institution. Moreover, the quality of these assets would be continually policed by the OCC just as they are today. Such an approach would allow the Federal Reserve to provide liquidity in a crisis without exposing itself to loss.

Under this concept, only the capital for the FDIC insured and the money market bank would be regulated. The capital for the holding company and for its other subsidiaries would be determined by the marketplace. Holding companies and unregulated subsidiaries, which took unwise risks, would be allowed to fail and investors in those subsidiaries would be subject to losses.

If there is any silver lining in the thrift crisis, it is the possibility that we can muster sufficient national will to undertake the broad deposit insurance reform that we need. I believe the integrity of our financial system is at stake. I believe all of us, not just the affected institutions, have a massive stake in these issues. I believe the time has come for the federal government to act.

The **Chairman**. Thank you very much. That was very direct and to the point and of course we have your full technical statement which has been distributed to the members.

Mr. Carron, we would like to hear from you next.

STATEMENT OF ANDREW S. CARRON, DIRECTOR—MORTGAGE RESEARCH, FIRST BOSTON CORP., NEW YORK, NY

Mr. **Carron**. Thank you, Mr. Chairman.

I have not done sufficient research to comment on the magnitude of the cost, but I would like to make a few comments about where the money went, whether it turns out to be $50 billion or $100 billion—how did that much money get out of the savings industry and where did it go?

WHERE DID THE MONEY GO?

First of all, holders of low interest rate mortgages, 6 to 9 percent mortgages, who took out those loans in the 1960's and the 1970's in effect reaped a windfall when market rates of interest rose to 15 percent and higher in the early 1980's. My estimates at the time were that the cost to liquidate the thrift industry back in 1982 at the peak of interest rates would have been about $90 billion. Now a lot of that was recovered when interest rates subsequently declined, but that was certainly part of the cause of the problem by depleting the capital of the industry.

Second, money was lent to individuals to buy property at the peak of the market and then property values declined and a lot of those loans went bad. So people who sold out at the peak of the market in places like Texas they took home some of the money.

The cost is indeed growing by the day. Where is that money going? What are the causes of that runoff? Well, there are many employees, many offices in the thrift industry that are not fully utilized, that are not productive, that are operating inefficiently; so you have these efficiency losses. You also have very high rates of interest paid to depositors in insolvent thrifts to compensate for the uncertainty over the full faith and credit guarantee for deposit insurance and over the future health of the institution. And, as several members have pointed out, there has been to a certain extent fraud and abuse in the industry.

So I think that if I can make those comments about the sources of the loss, that perhaps will help you in your deliberations about what the causes of the problem were.

FINANCING THE COST OF THE PROBLEM

Let me go on to address the other issues that you posed to the witnesses. How should the cost of dealing with the problem be financed? I think initially that you should attempt to recover what you can from the assets of the failed thrifts. I think there's very little disagreement about that.

Next, I think it would be unproductive to raise thrift deposit premiums any further than they already have been raised. To do so would worsen the competitive inequality between thrifts and banks and it would exacerbate the situation A very large percentage of those assessments today is already being paid by insolvent or marginally capitalized thrifts and you could make the problem worse by raising the premiums.

However, you should consider whether or not the current level of thrift premiums is appropriate. After all, deposit insurance is valuable and it should be fairly priced. If deposit insurance were explicitly made a full faith and credit guarantee of the Government through appropriate legislation, I think it would make it more valuable still and would justify the current level of thrift premiums.

Indeed, if that were done, raising bank insurance premiums should at least be considered. This would help achieve competitive equity between banks and thrifts, would provide a reserve for future bank problems, and perhaps it should be used to finance part of the thrift problem. After all, banks do benefit from having the financial stability that comes from a widespread deposit insurance system and to the extent that the thrift industry has lost business, has lost deposits, as a result of its problems, I think the banks have gained.

Next, I don't think it would be appropriate to impose fees directly on consumers for either deposits or mortgages. There are high administrative costs. The incidence is regressive. It would hit the small depositor, the lower and middle incomes the hardest. You would get more disintermediation, more funds flowing out of banks and thrifts because of the way that such a tax would fall. On the borrowing side I see no justification for dunning the borrowers. The mortgage borrower is not really the beneficiary of deposit insurance. I see no evidence of cross-subsidy between deposit insurance and mortgage rates.

Some have suggested looking at the various federally related agencies such as the Home Loan Bank System, Freddie Mac, Fannie Mae. I don't think there is enough capital in those agencies collectively to make a dent in the problem. Also, they have done a good job. They are not to blame for the problems. These agencies are needed to help housing finance keep moving as we find a resolution to the thrift problem. Finally, I think any attempt to attach their capital would upset the capital market and might therefore ultimately be counterproductive.

Now the Financing Corporation, FICO, was created to assist in the recapitalization of the industry and there has been some suggestion that FICO borrowing authority be increased. If that were done, then support for repaying the FICO debt must be broadened to ensure repayment of the funds. Otherwise, financing in the capital markets would be difficult to obtain.

I think that the plans that have been discussed to raise large amounts of funds in a short time through long-term bond issuance is a good idea if it leads to a more rapid resolution of the problem. I think ultimately, after all the sources I've discussed have been exhausted, there's still going to be a substantial residual cost which, unfortunately, only the Federal Government can pay.

SEPARATELY REGULATED THRIFT INDUSTRY

Let me turn next to the need for and the viability of a separately regulated thrift industry. I believe that thrift viability over the long run is threatened by a return to traditional mortgage lending which, according to my research, has not been profitable for at least the last 5 years. As Mr. Bryan said a few moments ago, even the healthy portion of the industry is much smaller and much weaker than some of the figures that members cited may indicate because of the way the accounting is done in this industry.

I think in retrospect it is now apparent that traditional mortgage lending started the situation unraveling in the late 1970's. The new asset powers which were granted to the industry did not directly cause the problems we have today, although it did make it easier to take risks, more costly to resolve problems, and more difficult to detect incipient difficulties.

Therefore, I think reregulation is a mistake if reregulation means a return to the narrow concept of a highly specialized depository. Reregulation would be useful if that term means close supervision and enforcement of capital requirements, lending limits and other safety and soundness provisions.

Thrifts do support the housing market. They do so in many ways. But they are only required to support it in one particular way and that is by holding a certain percentage of their assets in mortgage loans. All of the other things that they do, such as originating mortgage loans, servicing them, selling them, developing new loans types and so forth, they do by choice and for profit. Like banks and other entities, they would continue to do these things with or without separate regulation.

I don't think that thrifts are quite the reliable home lenders that we assume them to be. They are the first to drop out of the market when money is tight. Ten years ago thrifts provided just over ½ of the new mortgage credit provided for residential mortgages. Today that figure is down to one-quarter. Regulation really forced this result because it did not require thrifts to make new loans or increase their holdings of loans, it just required them to hold a certain percentage of their assets in mortgages.

The reason for a lot of these developments is that the secondary market has made the holding of the basic mortgage loan a generic commodity—standardized, low-cost, high volume. Therefore, I think that thrifts should be permitted, but not required, to hold mortgage loans in their portfolios.

Finally, let me talk about what I see as the necessary regulatory and structural changes to avoid a problem like this in the future.

I think that coordination of State and Federal regulation, examination, supervision, and enforcement should be improved. I believe that uncoordinated actions by State regulators delayed detection of problems and the implementation of solutions. Ultimately there will be disagreements between State and Federal regulators on matters of safety and soundness. I think these should be resolved in favor of the deposit insurance agency.

I believe that financial institutions should report financial results on the basis of current value accounting or mark-to-market, at least for regulatory purposes, because this would provide an early warning for problems.

Capital requirements should be adjusted to protect the deposit insurance agency from loss in the event of insolvency. This means there should be enough capital to encourage prudent management and to provide a buffer for the insurance agency between the time that the problems are first detected and the time that enforcement can begin.

The real key, though—and I think the real failing in terms of regulation over the last several years—is that the regulators must intervene before the market value of the financial institution reaches zero. Other reforms such as changes to deposit insurance would be useful but would be much less important if a strict closure rule were in effect.

Thank you.

[The complete prepared statement of Mr. Carron follows:]

Statement of

Andrew S. Carron
Director - Mortgage Research
First Boston Corporation
New York

before the

Committee on Banking, Housing, and Urban Affairs
United States Senate

January 31, 1989

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to testify on the current condition of the savings and loan industry. I have studied the industry extensively since 1980, when I was a senior staff member in the economic studies program of the Brookings Institution. I am currently manager of the mortgage research department of the First Boston Corporation, where my current responsibilities include evaluating the impact of the savings and loan situation on the secondary mortgage market, advising thrift institutions on asset-liability management, and analyzing investment opportunities.

At the Committee's request, I am appearing today as an industry expert. I will express my personal views only as I am not appearing on behalf of First Boston.

My testimony will be in three parts, corresponding to three of the questions that the Chairman has posed to the witnesses: How should the cost of dealing with the problem of the savings and loan industry be financed? What is the need for, and the viability of, a separately regulated thrift industry? What regulatory and structural changes are necessary to ensure that the problem does not recur?

Financing the Costs

It is my opinion that:

1. *The largest share of the costs should be paid out of general revenues. Theoretically, these payments could be accounted for by restating financial results for the years in which these liabilities were incurred.*

2. *Deposit insurance premiums should be equalized for banks and thrifts.*

3. *Specific taxes on the thrift industry would be counterproductive and should be avoided.*

4. *Involving government sponsored enterprises in the thrift industry recapitalization would yield a relatively small amount of resources, but would reduce efficiency and raise costs in housing finance generally, and should therefore be avoided.*

No single cause was responsible for the reduced earnings and widespread failures of thrifts during the 1980s. The relative contributions of the various factors are difficult to distinguish, and may vary substantially from case to case. There are two parts to this issue.

First, why did large numbers of thrifts lose money and ultimately fail? This is a legitimate matter of concern for the individual institutions involved and for the thrift industry as a whole.

Second, why have these thrift losses and failures imposed high direct and indirect costs on healthy thrifts, government agencies, the banking system, and the economy? I believe this issue should be the focus of public sector involvement.

The failures could have occurred without imposing a burden on other firms or sectors of the economy. The crisis has so far spawned substantial indirect costs and the likely prospect of a large direct cost. Failing thrifts have bid up deposit costs and impaired the health of solvent banks and thrifts. FSLIC insurance premiums were raised 150 percent. That the thrifts' problems did create spillover effects should be the main concern for public policy. Such costs raise interest rates, reduce investment, and therefore impair future economic growth.

Individual thrift institutions may have contributed to their own demise, but were not responsible for the growth of the FSLIC's liabilities beyond its resources. Contributing causes to the public crisis were the depletion of the industry's net worth in the early 1980s, the existence of federal deposit insurance, inadequate examination and supervision, and a lack of coordination between state and federal authorities. Most important, however, was the federal regulators' inability or unwillingness to close institutions prior to insolvency.

To the extent possible, the government should seek restitution from those thrift owners responsible for the risk-taking and the costly failures. There were also failings in the regulatory process, so part of the cost rightly should be paid by the government. These government liabilities have been incurred over the past decade, and thus should not be consided "new" expenditures.

Furthermore, as a practical matter, there will have to be federal contributions, regardless of whether the ultimate cost turns out to be $50 billion or $100 billion or more. While depository institutions derive substantial benefits from the deposit insurance system, additional insurance premiums on the thrift industry might be counterproductive. The current disparity between bank and thrift premiums represents a serious competitive inequity, and this should be addressed. But higher premiums overall, even if levied equally on banks and thrifts, might raise the incidence and cost of financial institution failures by raising operating expenses and by encouraging disintermediation.

Seeking additional resources through the Financing Corporation or the Federal Home Loan Bank System, without Congress providing the agency with additional funds or credit support, would similarly be inappropriate. To do so would depress the value of outstanding agency debt and raise financing costs, which ultimately are paid by the thrift industry. The repercussions in the capital markets could have a deleterious effect on the cost of housing finance to homebuyers.

Separate Thrift Industry

It is my opinion that:

Thrifts will continue to play a major role in the provision of housing finance. Thrifts cannot be viable if compelled to hold home mortgage loans as their principal assets, because developments in the secondary market have lowered most mortgage rates below thrifts' costs. Regulation of thrifts should be rationalized to permit, but not require, thrifts to invest in home mortgage loans.

Thrift institutions engage in a variety of mortgage-related activities. They originate and service whole loans, and they trade and hold both whole loans and mortgage related securities. Mortgage-related revenues come from origination and servicing fees, coupon interest, gains on sales, and miscellaneous sources such as prepayment penalties and escrow accounts. The legal definition of a thrift, however, is quite narrow: an institution that, once chartered as a savings institution, holds a specified percentage of total assets in mortgages and/or mortgage-backed securities.

Of course, if these regulations were removed, there would be little substantive distinction between thrifts and banks. That event, some would say, is tantamount to abolishing the thrift industry and would result in flooding of the market with the $1 trillion in mortgages held in thrift portfolios. However, the thrift industry, as a statutory definition, must be distinguished from the 3,300 individual thrift institutions that comprise it. The firms themselves, and their mortgage assets, would remain intact if their industry definition were changed. Many, if not most, would choose to continue their specialization in mortgage-related activities, but it would be specialization by choice rather than by regulation.

Substantial diversification away from mortgages has already taken place. Among the many activities engaged in by thrifts, traditional single-family mortgage lending (portfolio investment) is the only activity to have a clear decline since the beginning of the 1980s. Mortgage banking activity has increased, as evidenced by an increase in the ratio of loans serviced to loans held from 3% in 1980 to 24% in 1988. Some thrifts have shifted their asset mix away from mortgage loans toward investment securities (other than mortgage-backed securities). Such assets have contributed a greater share of income in recent years. The share of assets devoted to real estate development has increased nearly 50 percent since 1980. Thrifts are also beginning to offer a full range of nonmortgage loans, paralleling the services provided by commercial banks. The share of nonmortgage loan assets has increased substantially, as the revenue share from those sources has doubled.

The modern thrift industry was established to provide a source of funds for housing that would be both deep and reliable. Since more than half of all mortgages are now held by nonthrifts, the issue of depth has become moot and reliability has become the test of the thrift industry's contribution. Because they must hold a certain percentage of their assets in mortgages and because of the advantages conferred by their thrift status, it is said, thrifts will supply funds to the market when other participants will not.

Analysis suggests that thrifts may actually be less reliable lenders than market participants who have no particular advantages or incentives in holding mortgage loans. It appears that the constraints on thrift operations offset the motivation to increase lending when funding is tight.

In a recent paper, a colleague and I examined thrifts' share of mortgage originations over the business cycle. Mortgage funds become more difficult to obtain when interest rates are high, so if thrifts have an advantage one should observe an increase in thrifts' market share when interest rates rise. The opposite seems to occur.

From January 1973 through September 1979 (immediately prior to the shift in Federal Reserve monetary policy), mortgage rates averaged less than 10%. During this period, savings and loan associations accounted for 50 percent of the 1-4 family mortgage originations by dollar amount. S&Ls also purchased slightly more loans than they sold, raising their net share of acquisitions to 51 percent of the total.

From October 1979 through June 1982, mortgage rates averaged nearly 15%. Gross originations by S&Ls declined to 42 percent of the total. Furthermore, sales substantially exceeded purchases, lowering the net acquisition share to 35 percent.

Since July 1982, mortgage rates have trended irregularly lower. Thrifts' share of gross originations has not recovered, however, remaining near 40 percent. Net sales have driven net acquisition down to about 26 percent of the total.

In recent years, mortgage lending has been intermittently profitable for thrift institutions. Traditionally, thrifts funded higher yielding long-term mortgage assets with lower yielding short-term funds, paying expenses and a return on capital with the yield spread. Despite a recent narrowing of the maturity gap between assets and liabilities, the effective duration of thrift assets is still longer than that of thrift liabilities. Thrifts earn a positive spread from portfolio loans when interest rates decline or remain stable. When interest rates rise sharply, the typical thrift loses money. So thrift performance, even in recent years, is largely dependent on whether interest rates have risen or fallen. Historical performance measures are therefore not a good indication of the profitability of portfolio lending in general.

Expected profitability of mortgages is further complicated by their complex cash flows. Because mortgages amortize and pay interest periodically, investors are exposed to substantial reinvestment risk. If market interest rates decline, mortgages may be refinanced, depriving lenders of anticipated interest income. As a result, the yield (internal rate of return) of a mortgage, computed at the time it is acquired, overstates its expected total rate of return.

New techniques for the valuation of the complex options embedded in residential mortgages now make it possible to compute ex ante expectations of portfolio profitability. Through these methods, I found that, for most of the 1982-88 period, thrifts could not anticipate profitable investment in conforming fixed-rate mortgages.

Large-scale investment in adjustable rate mortgages has occurred too recently to perform a similar analysis for ARMs. Over the last year adjustable rate mortgages have offered higher risk-adjusted returns than comparable fixed-rate mortgages. Even higher expected returns are available on less liquid instruments such as mortgage strips, collateralized mortgage obligations, nonconforming mortgages, and non-agency pass-through securities. These investments have been sources of profits in the past, but cannot be expected to remain profitable as those markets become more liquid.

In recent years, thrifts could expect barely to break even on their investment in mortgages. It is not a paradox, however, to say that the mortgage lending business, viewed in its entirety, may be profitable. Mortgage lending entails many steps, of which holding the pure loan in portfolio is only one. Thrifts have profited from the non-investment aspects of the mortgage business.

The development of a secondary mortgage market and a variety of mortgage-related securities has removed many of the obstacles faced by investors who wished to invest in mortgages. Thrifts no longer have a comparative advantage in holding "unfamiliar" and "illiquid" long-term amortizing mortgages, and may even be at a disadvantage because of their portfolio restrictions. But mortgage securities have not greatly affected the other attributes of mortgages, and it is in these areas that thrifts continue to excel.

Thrifts have profited from mortgages as the result of unexpectedly favorable interest rate moves, superior underwriting abilities, efficiencies in loan servicing, fees collected for loan origination, and intermediation between more and less liquid instruments. They may also have benefited from below-market liability costs, marketing and cross-selling advantages, and imperfect consumer information. Of course, none of these profits require the mortgage loan to be held in the thrift originator's own portfolio.

Under current conditions, the thrift industry will never attain consistent profitability, a fair return on invested capital, and a stable role in the provision of housing finance. If nothing is done, the industry will decline and impose further costs on the deposit insurance system. Three alternatives suggest themselves: (1) make mortgage investment more profitable for thrifts; (2) make mortgage investment less profitable for non-thrifts; (3) remove the requirement that thrifts invest in mortgages.

Increasing the profitability of thrift mortgage investment. Thrifts can continue to seek out the new and less liquid mortgage instruments that historically have provided an attractive rate of return. However, all such instruments ultimately lose their advantage. This strategy would require too high a rate of turnover to be consistent with large thrift holdings of mortgages. Other approaches would entail some form of direct or indirect (tax) subsidy to encourage thrifts to hold mortgages.

Decreasing the profitability of non-thrift mortgage investment. The advent of mortgage securities has been the factor most responsible for the reduction of mortgage yields. Limiting the ability of the federally related agencies to issue and guarantee mortgage-backed securities would clearly raise mortgage yields. This cost would be paid directly by mortgagors, and would decrease the availability of housing finance.

Removing thrift portfolio restrictions. The only viable solution for the future is removing the requirement that thrifts hold 60 percent of their total assets in housing related instruments. Thrifts need the flexibility to adjust their portfolios in response to changing market conditions. They would likely continue to be active participants in the origination and servicing of loans. Even if the share of mortgages in their portfolios were to decline, the impetus for growth and investment in thrifts would likely increase the aggregate mortgage holdings of the industry. Coordination or consolidation of bank and thrift regulation is a necessary component of this approach, as thrifts come to be identified more by the functions they perform than by the charter they hold.

Regulatory and Structural Changes

It is my opinion that:

1. *Coordination of state and federal regulation, examination, supervision, and enforcement should be improved. Disagreements between state and federal regulators on matters of safety and soundness should be resolved in favor of the deposit insurance agency.*
2. *Financial institutions should report financial results on the basis of current value accounting, at least for regulatory purposes.*
3. *Capital requirements should be adjusted to protect the deposit insurance agency from loss in the event of insolvency.*
4. *Regulators should intervene – through liquidation, receivership, or conservatorship – before the market value net worth of a financial institution reaches zero.*

State-federal coordination. By legislation and regulation, many of the federal restrictions on thrift assets were removed between 1980 and 1984. State-chartered institutions were frequently granted comparable powers when rules for federal thrifts were relaxed. Many states went beyond the powers approved at the federal level.

When thrifts began to implement their new powers, they faced three types of challenges: unfamiliar assets presented unfamiliar risks, late entry into a market left thrifts with the marginal credits, and market conditions became adverse just as thrift participation began. Many thrifts lost money as a result of their exercise of new asset powers.

Due to bad timing and other factors, problems occurred with assets newly authorized by both federal and state governments. Certainly the state authorities in many instances went beyond what the federal government was willing to grant. But where institutions had taken advantage of new powers to diversify their assets prior to the interest rate surge of the early 1980s, they registered better performance than thrifts with traditional portfolios for several years. That is because the riskiness of an asset is relevant only in the context of the entire portfolio. Whether these new assets increased or decreased risk depended on the covariances of their returns with those of traditional assets in the portfolio. From 1980 to 1984, 20 percent of FSLIC's problem cases were due to low asset quality and the balance largely to interest rates. Thereafter, 80 percent of the problems were attributed to poor asset quality.

The impact of federal and state powers is differentiated not in the effect on individual thrifts' profits, but rather in the growth of the problem beyond the thrifts immediately affected. The expansion of federal powers was sufficiently modest that it was within the existing ability of regulators to monitor. At the very least, the supervisory authority was party to the discussions on granting the new powers. When state regulatory authorities granted new powers to state-chartered institutions, and particularly when those powers went substantially beyond that which federally chartered thrifts were permitted, a gap was opened between the activities permitted and the ability of regulators to monitor those activities. Misjudgment, bad luck, and outright abuse were more likely to occur, especially among insolvent institutions, and less likely to be detected. The problem was the lack of coordination between liberalization at the state level and supervision at the federal level.

Beginning in 1984, the percentage of problem state-chartered institutions began to rise. Additional costs were incurred when federal efforts to curtail losses at failing institutions were constrained by state authorities. Increased investment flexibility should have been synchronized with increased surveillance by the federal deposit insurance agency. The dual banking system makes this type of coordination difficult if not impossible. Some of the public costs of resolving the thrift crisis may be traced to the right of state governments to make decisions without bearing full responsibility for the financial consequences.

Current Value Reporting. Early signs of problems were evident at least 15 years ago. The book value of thrift net worth declined through the 1970s while interest rate volatility increased. Analysts warned of the implications of relying on Regulation Q and of funding long-term assets with short-term liabilities. Had mark-to-market reporting techniques been in place, thrift managers and regulators would have been alerted to the deteriorating real financial condition of the industry.

The regulators could have avoided claims on the deposit insurance funds by addressing the maturity mismatch earlier or by intervening when net worth was still positive. Instead they took the opposite approach. Regulatory capital requirements were repeatedly lowered. Phase-in and averaging rules further reduced minimum net worth levels. Relaxation of accounting standards made these limits even less binding. Even so, many institutions failed to meet the requirements, yet were not closed. By 1986, over 18 percent of FSLIC-insured thrifts failed to meet regulatory net worth requirements, and 79 percent would not have met the stricter rules that had been in effect until 1980.

The decision by regulators to allow institutions with low or negative market-value net worth to remain in operation during this period was essentially a bet that interest rates would decline. For several years, the bet did not pay off, and the agencies paid out claims. Market yields fell beginning in mid-1982, although it was 1986 before the market value of thrifts' mortgage holdings return to par. By then it was too late to recoup most of the losses. The depletion of FSLIC capital was a necessary condition for the subsequent inability of the agency to close institutions as quickly as it desired.

Capital. Capital serves two purposes. It provides an incentive for the owners to balance risk against return, as described above. It also provides a buffer for the insurance agency against uncertainties in the valuation of assets and liabilities.

The thrift industry's real capital position had been lagging behind its growth in assets for a decade by the time interest rates started moving up in 1978. At the beginning of the 1970s, net worth exceeded 7 percent of assets on a book value basis and was nearly 5 percent on a market value basis. At the end of 1979, book value net worth was less than 6 percent of assets, and although the liquidation value of the thrift industry's assets was still slightly positive, it had gone below zero by the end of 1980. This was a necessary condition for the risk-taking activity that followed.

A sound deposit insurance system must incorporate measures to protect against excessive risk-taking. When the insured party reaps the gains of success without bearing the costs of failure, there is little incentive to act prudently. This "moral hazard" problem, as it is called, is usually avoided through deductibles, wherein the insured shares in the loss, and limitations on the insured's scope of action. In a deposit insurance system, capital serves the function of the deductible and regulations are intended to limit risky behavior. When real capital is depleted, as it was at many thrift institutions by 1983, institutions have an incentive to increase leverage and take on risky assets -- that is, investments with a high variance of returns. At that point, regulation is the only bulwark against moral hazard, and rules were being relaxed rather than tightened at the time.

Closure rule. As the net worth of thrift institutions was depleted during the early 1980s, many institutions slipped below regulatory capital minimums. At that point, they could have come under strict supervisory control, and in the absence of financial recovery ultimately they would have been closed or merged. Had this procedure been followed, thrift losses and failures would still have occurred but costs in excess of the FSLIC's existing resources would have been limited if not entirely avoided. Instead, the capital requirements were reduced from 5 percent to 4 percent in 1980, and to 3 percent in 1981. Also, goodwill and appraised equity capital were added to assets, while losses on loan sales were partially excluded. The FSLIC provided net worth certificates, income capital certificates, and mutual capital certificates to problem institutions. These measures inflated regulatory net worth by over $13 billion relative to GAAP net worth. Yet even institutions that failed to meet these relaxed rules were permitted to remain in operation. The agency was unable or unwilling to close large numbers of thrifts. By the time the magnitude of the problem was recognized the FSLIC's resources were no longer adequate, its staff was insufficient for the number of problem cases, and its preferred method for handling problems -- assisted mergers -- was losing popularity among potential buyers. On average, insolvent thrifts remained open for nearly twelve months before they were closed.

STATEMENT OF PAUL M. HORVITZ, ELKINS PROFESSOR OF BANKING AND FINANCE, UNIVERSITY OF HOUSTON, HOUSTON, TX

Mr. Horvitz. Thank you, Senator Gramm, for those kind words. I am honored to be asked to testify here on the opening day of this very important set of hearings.

My statement is brief. I have attached to it a paper I recently prepared evaluating the Southwest plan deals and I have also attached a proposal recently issued by the Shadow financial regulatory committee of which I am a member dealing with reform of the deposit insurance system.

I will summarize the main points of my statement.

The problem may be somewhat smaller than some estimates. In 1988, FSLIC dealt with 64 percent of its Texas case load at a cost of about $25 billion. That suggests total Texas costs of about $38 billion. If Texas is half the U.S. total, as a number of experts have suggested, then that implies a total FSLIC cost of about $75 to $80 billion.

But pinning down the exact amount doesn't matter because if we're in that ballpark we are committed to paying it, whatever the bill is, and that amount is way beyond the existing capability of FSLIC and the savings and loan industry.

The most important thing in my view is that it is crucial to get cash to FSLIC from the Treasury promptly. And I say Treasury because any other source of funds will be more costly. Providing Treasury cash to refinance FSLIC can be done in several ways.

TREASURY SHOULD SUPPLY THE CASH

My preference would be to have FSLIC and the FDIC give their funds back to the Treasury. They would then be authorized to write checks on the Treasury as needed to meet deposit insurance obligations. This would eliminate the fiction of deposit insurance funds, a fiction since deposit insurance and the confidence of the public doesn't depend on the existence or the size of these funds. Of course there will be a need for oversight to assure that the funds are being spent wisely, but FSLIC is getting plenty of that oversight right now anyway.

There are other ways of getting funds to FSLIC. It could be in the form of a loan, as Senator Heinz suggests. I have no objection to calling it a loan as long as it's clearly understood that there is not a chance in the world that such a loan would ever be repaid.

Full faith and credit for FSLIC notes would be helpful but not sufficient because FSLIC should liquidate some institutions and liquidation requires cash. That brings us to analysis of the Southwest plan deal.

I have been critical of the deals because they result in institutions that are too thinly capitalized. Not enough private capital has been attracted to these deals. The reason is clear. These are massively insolvent institutions. FSLIC does not have sufficient cash to fill the negative net worth hole in these insolvent institutions. A rational private investor is going to be unwilling to put his money at risk until that deficit is filled. Given its lack of cash, FSLIC has attempted to meet its deposit insurance obligations with those resources at its disposal—issuance of notes and granting of tax benefits and forebearances. Acquirers are willing to do deals in which the deficit is not completely filled or is filled with notes rather cash, but only if they do not have to put up the normal amount of capital.

Further, acquirers are willing to accept notes only if the FSLIC note can be liquified by using them as collateral for borrowing from the Federal Home Loan Bank. As a director of a Federal Home Loan Bank, an institution which is owned by its member stockholders to whom I owe a fiduciary duty, I am increasingly uncomfortable in that situation.

These deals strike me as the best that can be done given the resources FSLIC has available. In particular, the criticism that the Bank Board has exceeded its authority by issuing billions of dollars of notes without congressional approval is irresponsible. Congress has clearly spoken that deposit insurance obligations must be met. The Bank Board has sought to meet that obligation with the resources available to it.

The same comment applies to tax benefits. Congress passed the tax provisions and even extended these tax benefits recently to FDIC assistance. Since Congress wants FSLIC to resolve cases, Congress granted the tax powers and denied FSLIC the cash it needs, it's clear that the responsibility for the excessive cost to the Treasury of these tax-driven deals lies with the Congress. FSLIC has done the best it can, though I deplore the type of transaction that result when one party is in a weakened bargaining position.

Despite the importance of providing cash to FSLIC promptly, many are reluctant to see a large payment until changes in the system have been made so that they can be sure that the debacle will not happen again. The chairman has made that point very forcefully.

The problem is, the bill that must be paid is for already existing losses. Even if we knew that this problem was going to repeat itself 50 years from now or 20 years from now or 10 years from now, we still have to pay the bill for the already existing losses. Of course, Congress should give consideration to reform of the financial regulatory system and the deposit insurance system, but I fear that linking agreement on reform to refinancing FSLIC means an expensive delay in getting cash to FSLIC.

I am personally less concerned about the immediate need for regulatory reform because I believe we've learned enough from our current difficulties that the disaster will not be allowed to happen again. But I do have a reform proposal to recommend.

A SOUND REGULATORY SYSTEM

The shadow financial regulatory committee, a group of economists and lawyers who have long been concerned with matters of financial regulation, has recently issued a proposal that focuses on the major need of a sound regulatory system. These essential elements are a rigorous capital requirement, a good monitoring system. We favor a shift from GAP to market value reporting of assets and liabilities, and an ability of the regulator to take over institutions before they become insolvent.

Under our proposal institutions would be subjected to increasing supervisory constraints as net worth falls closer to zero.

But even in the absence of positive action, I don't believe a repeat of the current disaster is likely. We have certainly learned enough that we will not see in the future the perverse actions we saw during the 1980's, a proliferation of accounting gimmicks used to justify delays in supervisory action, a reduction of net worth requirements just when we needed them, and the legislatively mandated forebearances of CEBA.

I can summarize my views rather briefly. Whatever the current estimate of the cost of the S&L debacle, it will increase until FSLIC can resolve its case load. FSLIC has been doing deals that are not optimal because it lacks the cash that is the necessary part of efficient deals with well capitalized acquirers. The recent deals may be wasteful because while we know that the government will deliver on FSLIC's promises and tax benefits, the potential acquirers cannot be sure of that. Hence, they will not pay 100 cents on the dollar for those promises. I believe the cheapest solution to the problem involves committing Treasury funds promptly to FSLIC case resolution. Once that decision is out of the way, this committee could turn its attention to the important longer range issues that are before it—reform of the deposit insurance system, reform of the regulatory agency structure, bank powers, and the role of specialized lending institutions.

Thank you.

[Complete prepared statement with a paper evaluating the Southwest plan deals and a proposal issued by the Shadow Financial Regulatory Committee follows:]

STATEMENT

TO THE

COMMITTEE ON

BANKING, HOUSING AND URBAN DEVELOPMENT

UNITED STATES SENATE

by

PAUL M. HORVITZ

JUDGE JAMES A. ELKINS PROFESSOR
OF BANKING AND FINANCE

UNIVERSITY OF HOUSTON

JANUARY 31, 1989

I have been asked to address several questions. All raise issues that are interesting from the point of view of both academic economists and legislators. But some of the issues must be resolved promptly, while others can be the subject of more leisurely consideration.

It is interesting, for example, to speculate about the total cost of savings and loan insolvencies. But it is not important to make that estimate with any precision because Congress has already determined that, whatever the cost, insured depositors are going to be protected. We do know that the total cost far exceeds the resources of the FSLIC and the savings and loan industry, and that is sufficient information to formulate an appropriate solution to the problem.

For what it is worth, I believe that the magnitude of the problem is somewhat smaller than some of the spectacular numbers that have been thrown around. My rather crude approach notes that about two-thirds of FSLIC's problem cases in Texas have already been resolved, at a cost of about $25 billion. The remaining cases are no worse, it appears, than those already resolved--in fact many of the very worst cases have been taken care of. That suggests that the total cost for Texas will amount to about $35-40 billion. A number of analysts have opined that Texas makes up about half of the national total, and that suggests, therefore, a total cost of about $75 billion.

But whether the final figure comes in somewhat lower than that, as Chairman Wall estimates, or higher, as Chairman Seidman believes, is irrelevant information as far as economic decisions are concerned. There is no question but that the cheapest approach is to use Treasury funds to resolve problems as soon as possible. While there are alternatives, any other approach will be more costly. You may choose one of the other solutions because of considerations other than cost. It may be possible to keep the cost out of the federal deficit, or to avoid triggering Gramm-Rudman, or to heap additional punishment on the healthy segment of the thrift industry, or it may be possible to design a solution so complicated (like the Farm Credit approach) that no one can understand it or criticize it. All I can say about these other approaches is that they will end up costing more than prompt use of Treasury funds.

Some of these additional costs are measurable. FICO bonds cost close to 100 basis points more than Treasury financing. That money is simply wasted. Nothing of substance is being bought with that 100 basis points. It is a payment to investors to compensate them for taking the risk that FICO will default--a risk that does not exist with Treasury responsibility for the liability. And the Congress has already decided that the Treasury has that responsibility.

Providing Treasury funds to refinance FSLIC can be done in several ways. My preference would have FDIC and FSLIC give their funds to the Treasury. They would then be authorized to write checks on the Treasury as needed to meet deposit insurance obligations. This would eliminate the fiction of deposit insurance funds--a fiction since deposit insurance does not depend on the existence or size of these funds. Of course there will be a need for oversight to assure that funds are being spent wisely, but FSLIC is getting plenty of that oversight right now.

An alternative would be legislation making explicit that FSLIC notes and assistance obligations are backed by the full faith and credit of the United States. While there have been legal opinions with respect to full faith and credit, Congressional action is necessary to remove any doubt, and to allow FSLIC obligations to be priced as Treasury obligations. Remember, FSLIC notes are not accepted as good as Treasuries even within the Federal Home Loan Bank System. Full faith and credit legislation would be helpful, but it is not a complete solution. For reasons that will be discussed, FSLIC needs cash.

There is room for argument as to how the new funds should be administered. There are many, both in Congress and in the thrift industry, who would like to see administrative responsibility stripped from the Federal Home Loan Bank Board--either because they believe that FSLIC is incompetent or because they seek vengeance for past wrongs. I don't have anything against vengeance in principle, but as a guide for public policy I would prefer to give weight to more forward-looking considerations. That is, rather than concluding that FSLIC or the Bank Board screwed up in the past, and using that as justification for a merger of FSLIC and FDIC, I would rather consider the question of whether FSLIC, as it is now, is the best institution to deal with the present problems.

While I have been critical of FSLIC actions (and inaction) in the past, FSLIC has demonstrated that now it can make decisions and complete deals. I am unhappy with some of the recent Southwest Plan actions of FSLIC for two reasons: First, in some cases liquidation would be better than keeping all the insolvent Texas shops in operation; second, the deals have resulted in institutions too thinly capitalized to provide confidence that a permanent solution has been achieved. There is good reason for this problem.

The reason that FSLIC cannot consider liquidations is simply that FSLIC does not have the cash that that solution requires. The reason FSLIC cannot attract more private capital to these deals is the same--FSLIC does not have sufficient cash to fill the negative net worth hole in these insolvent institutions. A rational private investor is going to be reluctant to put real money at risk until that deficit is filled. Given its lack of cash, FSLIC has attempted to meet its deposit insurance obligations with those resources at its disposal--issuance of notes and tax benefits. Acquirers are willing to do deals in which the deficit is not completely filled, or is filled with notes rather than cash, but only if they do not have to put up the normal amount of capital. Further, acquirers are willing to accept notes only if the notes can be liquified by using them as collateral for borrowing from the Federal Home Loan Banks. As a Director of a Federal Home Loan Bank --an institution owned by its member stockholders to whom I owe a fiduciary duty--I am increasingly uncomfortable in that situation.

I can not be certain that FSLIC would make perfect decisions if it had the necessary resources. Certainly the past record is not one that inspires confidence. But the criticism of recent deals, emanating from the media, from academics, and from the Congress, are inappropriate. These deals strike me as the best that can be done given the resources FSLIC has available. In particular, the criticism that the Bank Board has exceeded its authority by issuing billions of dollars of notes without Congressional approval is irresponsible. Congress has clearly spoken that deposit insurance obligations must be met. The Bank Board has sought to meet that obligation with the resources available to it. I commend the Bank Board for its courage in doing deals that subject it to criticism, even as I deplore the type of transactions that result when one party is in a weakened bargaining position. It is better to be criticized for action than for inaction.

I have great respect for the FDIC. I worked for the FDIC for ten years, and I am familiar with its abilities and record in dealing effectively with bank failures. But FDIC's capabilities have been strained to the limit in handling the record number of bank failures in recent years. I see no reason for believing that moving responsibilities for handling savings and loan failures to FDIC will improve decision-making in the short-run. In fact, if responsibility for thrift failures is transferred to FDIC, as many now advocate, it will probably be necessary to transfer FSLIC staff to FDIC. We will probably end up with the same people implementing policy, though they may be wearing different hats. The disruption involved in such a change is likely to result in delay and deterioration in case-resolution capability. In the long run, it may be appropriate to combine FDIC and FSLIC, and this Committee should give that matter serious consideration at some time in the future. At the present, in the absence of any solid evidence to the contrary, I believe that we are better off keeping the present institutional arrangement. The urgent need is to give FSLIC sufficient cash to do deals at the least cost. If they fail to use those resources effectively, then a change in organization should be made. I would prefer to give them a real chance.

Despite the importance of providing cash to FSLIC promptly, many are reluctant to see a large payment until changes in the system have been made so that they can be sure that the debacle will not happen again. I don't really see the logic to that, since the bill that must be paid is for already existing losses. Whether or not we change the system, or eliminate FSLIC or even federal deposit insurance, for that matter, the existing bill must be paid.

Of course, Congress should give consideration to reform of our financial regulatory system. But I fear that linking agreement on reform to refinancing for FSLIC means a long delay. That delay will be expensive. It is not possible to reach agreement on a reform package without lengthy hearings, debate and negotiation. And that is the way it should be. Regulatory reform is an important subject that deserves lengthy consideration. The rationale for linkage is that many authorities believe that agreement on reform will only be possible under the pressure of the need to refinance FSLIC.

I am less concerned about the need for regulatory reform because I believe that we have learned enough from our current difficulties that the disaster will not be allowed to happen again. But I do have a reform proposal to recommend. The Shadow Financial Regulatory Committee, a group of economists and lawyers who have long been concerned with matters of financial regulation, has recently issued an "Exposure Draft" of a proposal that focuses on the major needs of a sound regulatory system. These essential elements are: a rigorous capital requirement, a good monitoring system (we favor a shift from GAAP to market value reporting of assets and liabilities), and an ability of the regulators to take over institutions before they become insolvent. Under our proposal, institutions would be subjected to increasing supervisory constraints as net worth falls closer to zero. I have attached the Committee's Exposure Draft to my Statement.

It is interesting to note that the regulatory agencies may already have much of the authority needed to implement such a system. In particular, the recently announced Bank Board proposed net worth and early intervention regulations have much in common with the approach we recommend. But even in the absence of positive actions, I do not believe that a repeat of the current disaster is likely. We have certainly learned enough that we will not see in the future the perverse actions we saw during the 1980's--a proliferation of accounting gimmicks used to justify delays in supervisory action, a reduction of net worth requirements just when we needed them, and the legislatively-mandated forbearance of CEBA.

There is one other long-range issue which frequently gets tied up with discussion of FSLIC financing--the question of whether there is a "need" for a separate thrift industry. That is, indeed, an interesting question, but once again it is not one that has to be resolved this month or this year.

If there is a need for a thrift industry it can only be found as part of a public policy of promoting home ownership. A good case can be made that such a policy is a mistake. If we had promoted investment in plant and equipment over the years rather than investment in housing, we would no doubt have a more efficient manufacturing system. But I have no doubt that if we were to conduct a referendum we would find widespread public support for keeping home ownership as a major social goal.

Of course, we can promote home ownership by other devices than by creating a system of housing-oriented lending institutions. Other means would probably be more efficient, and if we were starting from scratch, we would probably make different choices of means of promoting housing. But these institutions already exist. They originate and hold the bulk of our home loans. It may be wasteful to destroy that system and replace it with something else. I have seen analyses that show that the combination of mortgage bankers and investment bankers originating and securitizing mortgage loans by issuing mortgage-backed securities is more efficient than the savings and loan system. But we do not have enough experience to be confident in that judgement and, in any case, it seems that it is savings and loans that hold most of the mortgage-backed securities that result. This is a question that certainly deserves careful attention, and should not be resolved as part of today's decision on FSLIC.

I can summarize my views rather briefly. Whatever the current estimate of the cost of the S&L debacle, it will increase until FSLIC can resolve its caseload. FSLIC has been doing deals that are not optimal because it lacks the cash that is a necessary part of efficient deals with well-capitalized acquirers. The recent deals may be wasteful because, while we know that the government will deliver on FSLIC's promises and tax benefits, the potential acquirers can not be sure of that. Hence they will not pay 100 cents on the dollar for those promises. I believe that the cheapest solution to the problem involves committing Treasury funds promptly to FSLIC case resolution. Once that decision is out of the way, this Committee could turn its attention to the important longer-range issues that are before it: reform of the deposit insurance system, reform of the regulatory agency structure, bank powers, and the role of specialized lending institutions.

THE FSLIC CRISIS AND THE SOUTHWEST PLAN

Paul M. Horvitz
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The financial problems of FSLIC will be a major concern of the new Administration in 1989. There is room for debate on the political and budgetary ramifications of various approaches to resolving the problem, but the economic substance of the resolution is already determined. One way or another, funds from the U.S. Treasury are going to be used to protect depositors in FSLIC-insured savings and loan associations. The debate about alternatives is limited to cosmetics and timing (and a distribution of the burden of the ex-post settling up).

Discussion of cosmetics consumes a great deal of time and paper, but is relatively harmless.[1] The potential for harm comes in when the discussion leads to a delay in taking meaningful actions, or when the policy decision is to delay action. Unfortunately, delay is always a feasible policy. Insolvent, FSLIC-insured institutions rarely face a liquidity problem. They have virtually no uninsured deposits, and insured depositors have confidence (correctly) that they are not at risk. Thus it is always possible to keep an insolvent institution in operation indefinitely. Yet this adds to the ultimate cost. These institutions are necessarily losing money on a monthly basis, as interest-earning assets are less than interest-costing liabilities, and operating expenses must be funded. The constantly increasing estimates of the cost of the FSLIC problem are partly due to new losses, and partly due to recognition of existing losses, but they are also partly due to the delay in resolving recognized problems.

While discussion goes on at a high level as to the ultimate solution of the problem, FSLIC must act on specific cases. During 1986 and 1987 FSLIC received much criticism for its seeming inability to make decisions and take action. When FSLIC recapitalization was first discussed in 1986, the U.S. League of Savings Institutions argued that recap should be limited to $5 billion--not because the League really believed that $5 billion was sufficient, but because of reservations about the ability of FSLIC to spend any more money wisely. FSLIC management also expressed the view that $5-6 billion per year was about all they could use efficiently.

FSLIC's capabilities were clearly improved in 1988. FSLIC developed its "Southwest Plan" for dealing with the Texas situation, and handled an impressive number of cases involving a huge volume of liabilities during the year. While many who have negotiated with FSLIC during the past year still have complaints about its procedures, policies, and decision-making, it is clear that FSLIC is acting on cases at a rate that warrants praise rather than criticism. That would certainly be true if the case resolutions themselves were good ones. The purpose of this paper is to evaluate these

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[1] An example is the proposal originated by former FDIC chairman William Isaac to have the Federal Reserve donate some of its annual net profits to FSLIC instead of to the Treasury. The economic effect of such an approach is identical with the Federal Reserve making its normal payment to the Treasury, and the Treasury providing the funds to FSLIC. Major efforts have also been made to find a way of moving funds from the Treasury to FSLIC without having an effect on the reported federal deficit.

FSLIC actions. The emphasis is on the Southwest Plan, since Texas is where most of the action has been, and that is still where the bulk of the FSLIC problems remain. The analysis is hampered by the unwillingness of FSLIC to make full disclosure of the financial details of its deals.[2]

The Southwest Plan represents a methodology for setting priorities for the many potential actions FSLIC could take in handling troubled Texas thrifts. At the time the Plan was announced in February 1988, there were 143 Texas savings and loans in the FSLIC caseload, with 104 of those already insolvent on a RAP (Regulatory Accounting Principles) basis. These represented more than half of the 281 thrifts operating in Texas. Rather than deal with these cases on a one-by-one basis, the Southwest Plan called for consolidating several insolvent institutions with a healthy institution or new entrant, such that the resulting number of Texas thrifts would be between 160 and 180. Buyers would not be free to pick and choose among insolvent shops, but would bid on packages designed by FSLIC. The institutions combined in each package would be from the same area and have other attributes that would facilitate their consolidation (i.e., users of the same data processing system or service bureau). There are greater savings in merging an insolvent S&L in San Antonio with a healthy San Antonio institution, rather than with one in El Paso. Such consolidations could allow for a closing of 400 of the more than 1800 savings and loan branches in Texas, thus reducing operating costs.[3] The planners also had faith in the existence of economies of scale that would allow reduction in total operating costs as institutions were consolidated.

The emphasis on non-interest operating expenses was appropriate, in that such expenses ("G&A" or general and administrative expenses) have been high in Texas, reflecting the expensive branch structure, the high costs of handling troubled loans and foreclosed real estate (and perhaps the costs of maintaining fleets of private jets). Some reduction in those costs is possible, but claims made by FSLIC that $600 million per year could be saved are implausible. Of course, saving even $200 million is all to the good, though it pales beside the $7 billion loss that Texas S&Ls experienced in 1987.

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[2] FSLIC defends its penchant for secrecy by arguing that if potential bidders for failed institutions knew the details of what FSLIC provided in previous cases, FSLIC's ability to negotiate good deals in subsequent cases would be compromised. That argument is almost certainly wrong, since a principal effect of the policy is to discourage potential bidders who lack a good feel for what kinds of bids are acceptable. Moreover, the policy is at odds with the FDIC which now (though not always in the past) does provide substantial information on the terms of its deals.

[3] The number of savings and loan branches in Texas is undoubtedly excessive. The branch structures were developed during the period in which commercial banks were not allowed to branch in Texas. However, as some critics were quick to point out, most of the land and buildings used as branches by savings and loans were owned by savings and loans and, in the current state of the real estate market, it was unlikely that an alternative use could be found for these properties. Thus the immediate potential savings may be less than they appeared.

Consolidation could provide benefits in the handling of foreclosed properties ("REO" or real estate owned). Many smaller institutions lack expertise in managing such properties (they also lacked expertise in making loans on such properties, but it is too late to do anything about that), and consolidation could allow the employment of specialists. REO represented 11.6% of the total assets of Texas institutions in September, 1988.

A quantitatively more important issue in consolidation is the effect on the cost of deposits. Much attention has been devoted to the so-called "Texas premium"--the higher rate that Texas institutions must pay to attract deposits. It is clear that severely troubled institutions have had to pay high rates for deposits, even though deposits are insured. This reflects a rational risk premium for such potential inconvenience as a delay in obtaining funds (or a premature repayment) if the institution is closed, or a reduction in rate by an acquirer. What is not so clear is whether the existence of these high rate payers in a market increases the rates that must be paid by sound institutions in that market. Most participants in the market believe that they will lose deposits if they do not come close to matching the high payers.

It is also not clear whether a merger combining several weak institutions can reduce the rates paid even if the total amount of funds needed is unchanged. While theory suggests that the risk premium offered by the consolidated, sound institution can be reduced, the effect on the overall market should not be significant. Advocates of the Southwest Plan claim that reducing the number of institutions bidding for funds will favorably affect rates.

An alternative source of funds for S&Ls is advances from the Federal Home Loan Bank System. Such advances must be collateralized, and many insolvent institutions have run out of collateral. Combining the insolvent with a sound institution with excess collateral may allow the substitution of advances for deposits with a reduction in demands on the brokered deposit market. This does reduce the total demand for deposits, and should, on the margin, reduce the cost of deposits for depository institutions.

Once FSLIC has put together a package of insolvent S&Ls, it then seeks a purchaser. The purchaser may be a "healthy" Texas thrift, an out-of-state thrift, or private investors. Legally, a bank holding company could acquire a troubled thrift, but so far no Southwest Plan deals have involved such purchasers. Both competitive bidding and exclusive negotiation have been utilized to complete a deal. Virtually all Texas thrifts have been anxious to participate in the Southwest Plan as acquirers (or survivors). One group hopes to negotiate deals that will improve their earnings and financial prospects. Another group is more interested in the forbearances that go with the deal--in particular, the assurance that they will not be closed down themselves in the immediate future. Those in Column A are more likely to insist on adequate compensation from FSLIC for the risks and efforts undertaken than those in Column B.

The institutions being acquired under the Southwest Plan have substantial negative net worth. Such institutions have typically used various accounting gimmicks (including some sanctioned by GAAP) that allow assets to be carried on their books at values well in excess of fair market value. Typically, a solvent rational investor will commit to recapitalizing its insolvent acquisition if FSLIC provides the resources to bring its net worth up to approximately zero. This will allow the purchaser to earn a market return on his investment.

The purchaser is generally willing to pay a modest premium (i.e., accept an institution with assets worth a little less than liabilities) for the "franchise value"--the charter, going business value, location, etc.--but this is not unlimited and not a charitable contribution. It is a calculation of the extent to which the tangible assets will generate above market returns.[4]

The amount contributed by FSLIC to fill the negative net worth hole is a settlement of its contractual insurance obligations. It is not an "investment," and FSLIC cannot expect, under normal conditions, to get this money back or to earn a return on it. A rational acquirer is not going to promise a return of these funds unless he gets something else in exchange.[5]

Any transaction involving an insolvent institution must deal with the risks inherent in its poor-quality assets. For some Texas institutions, past-due loans, REO and other high-risk real estate assets represent over 80% of total assets. No one has yet designed a very good basis for a contract between the insurance agency and a risk-averse purchaser that provides proper incentives for handling problem assets. Given the great uncertainty as to the "true" value of the assets acquired, the purchaser is reluctant to assume the risk without deducting a substantial risk premium from his offer. FSLIC can retain all the risk, but then there is a difficult agency problem: There is substantial evidence that the assets in question have greater value in the hands of an operating institution than when managed by a receiver or liquidator.[6] But if the surviving institution is protected against loss in handling these assets by a FSLIC guarantee, how can FSLIC be sure that the optimum effort is put forth in collecting on them?

FDIC policy with respect to this problem has made a 180° turn in recent years. During the 1960's and 1970's the FDIC handled most bank failures by arranging purchase and assumption transactions on a "clean-bank" basis, whereby the FDIC took all the questionable assets and turned a clean bank over to the acquirer. As the size and frequency of bank failures increased,

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[4] At one time this franchise value represented an entry fee into an otherwise inaccessible market, but now interstate banking laws have reduced this potential source of premiums.

[5] Analogies are sometimes drawn between the role of FSLIC and the operations of the Reconstruction Finance Corporation during the 1930's. The RFC supplied new capital (in the form of preferred stock) to more-or-less solvent banks. It could expect, and did receive, a return on that investment. There is a crucial distinction between making up a net worth deficit--an insurance loss--and recapitalizing a zero net worth institution--an investment that can expect a positive return.

[6] A debtor is likely to give higher priority to paying an operating institution that represents a potential source of future borrowing than to paying FSLIC. Empirical support for this position can be found in Bovenzi and Murton, "Resolution Costs of Bank Failures," FDIC Banking Review, Fall 1988, and James, "The Costs of Liquidating Failed Banks and Evidence on FDIC Forbearance," mimeo, 1988.

FDIC found that this policy threatened to swamp its liquidation capabilities (and FDIC also found, as noted above, that the assets had greater value in the hands of the bank), so FDIC began to leave more of the collection effort with the acquiring bank, but subject to FDIC guarantees or "put" provisions. The FDIC then became unhappy with the agency problems and the monitoring efforts implied by this problem. It has now attempted to do more deals in which the bidders are encouraged to do their "due diligence" in a thorough manner, and then keep all the assets of the acquired bank.

Regardless of the way the bad asset problem is resolved, filling the net worth deficit of insolvent thrifts involves a huge outlay of funds at a time when FSLIC's liquid assets are very limited. FSLIC has opted, therefore, to provide the necessary financial assistance to acquirers in the form of notes or guarantees rather than cash.[7] While some purchasers are happy to accept these notes as obligations of a U.S. government agency, others are reluctant.[8] Congress has indicated that the "full faith and credit" of the United States stands behind the deposit obligations of FSLIC, but it has not spoken explicitly on the FSLIC notes. The GAO has opined that these obligations are obligations of the U.S., but the Federal Home Loan Bank Board, perhaps wisely, has not asked the Attorney General for a formal opinion.

As should be clear from this description, in lieu of a cash payment sufficient to induce an investor to put his capital at risk in taking over an insolvent institution, FSLIC has provided three types of assistance: notes; a capital loss protection guarantee on certain assets; and an income maintenance agreement which guarantees income on certain assets at a specified spread over an index of cost of funds. It is likely that use of notes and spread guarantees increases the present value cost of FSLIC assistance (as compared with cash), since the investor must take into consideration the risk of FSLIC default. The capital loss protection may reduce FSLIC cost since it reduces investor risk (though, as noted above, it may increase monitoring costs).

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[7] Guarantees can fill the net worth hole by allowing the write-up of previously written down assets. Consider an asset with an original book value of $10 million that has been written down to, say, $6 million. If FSLIC guarantees a market rate of return on the original $10 million, then that asset is, once again, worth $10 million. Obviously, the future cost of income support on the $10 million has to be factored into FSLIC's estimate of the present value cost of the transaction, but this does not require an immediate outlay of cash nor an issuance of FSLIC notes.

[8] Such willingness is not randomly distributed. It appears that bidders with substantial net worth are more reluctant to accept the notes than those without real equity at risk. Concern about the notes (or how their accountants would treat them) was reported to be a major reason why Ford Motor backed away from acquisition of FCA.

As a way around this problem, FSLIC has been reported to have offered a "pocket charter" to at least one potential note recipient. The federal S&L charter would be kept in the pocket of the acquirer unless FSLIC defaulted on its notes. In that case the charter would be activated, and the notes and an equivalent amount of deposit liabilities would be transferred to the newly chartered institution. That institution would upon inception be insolvent (since the notes would have little or no value), and FSLIC would take over. The acquirer would thus be assured of value for the notes (by reducing liabilities), but would substitute the risk that the courts would throw out this kind of Mickey Mouse device.

Despite these considerations, FSLIC has found that it can negotiate deals that do not require it to make the full contribution that they imply. Some buyers are willing to acquire insolvent S&Ls with a smaller amount of assistance. There are two classes of such bidders. One consists of weak S&Ls that, as noted earlier, are particularly concerned that they may be subject to supervisory action themselves. (Deterioration of financial condition can proceed so swiftly in Texas that some institutions seen as acquirers when the Southwest Plan was announced in February have become insolvent shops acquired by others). Weaker institutions hope to preclude that by being chosen as acquirers, thereby gaining either formal forbearances from net worth requirements, or at least an aura of being cooperative and helpful that may preclude strong action being taken against them. Since FSLIC will presumably put substantial additional responsibilities only on managements they consider competent, designation as an acquirer may prevent the regulators from criticizing management capabilities, at least for a while.

The second group of bidders consists of those who are willing to accept less than a zero net worth acquisition, provided they are required to put up less than the normally acceptable level of new capital. Their expected returns will be less than the normal return as a percentage of assets, but an acceptable rate of return on their investment.

In transactions involving both such groups certain aspects of the deal are similar: in both cases the resulting S&L will start out with less than the normal level of capital. Also, both these groups will generally be willing to accept FSLIC notes without qualms. Such transactions may be done with strong purchasers, but then the tendency will be to structure the S&L so that it is a separate subsidiary rather than merged into the acquiring firm.

In most FSLIC-assisted transactions tax considerations play a key role. All of the insolvent institutions have, by definition, incurred substantial operating losses. These net operating losses (NOL) can be carried forward and have real value to a tax-paying acquirer. In addition, the assistance payments made by FSLIC are tax-exempt income. These tax benefits are important to FSLIC, and reduce FSLIC's cost of negotiating case resolutions, but they do not reduce the social costs. Every dollar that FSLIC saves through this device is a dollar that IRS loses. In fact, there is likely to be a net cost here. A rational acquirer of an insolvent thrift is going to assess the potential tax benefits and make an offer to FSLIC that reflects his estimate of their value, discounted to reflect the risk that changes in tax law may take away some of that benefit or that they may not have sufficient earnings to use the tax benefit. Anyone can receive $1.00 of tax credit simply by paying the Treasury $1.00. The tax benefits of doing a deal with FSLIC are attractive only if the taxpayer can obtain $1.00 of tax credit by paying FSLIC less than $1.00. It is probable, therefore, that IRS loses more than one dollar for every dollar that FSLIC saves. And while FSLIC always seeks to minimize its costs, it is not clear that FSLIC seeks to minimize the combined costs of FSLIC and the Treasury.

As of year-end 1988, FSLIC has completed deals under the Southwest Plan with 15 different acquirers, involving 87 insolvent thrift. FSLIC originally estimated that the cost of resolving insolvencies in Texas would be $6-7 billion, but the transactions consummated so far have an estimated cost to FSLIC of nearly $25 billion. At the time the Southwest Plan was announced, there were 104 RAP insolvent thrifts in Texas. After resolving these 87 cases, there are now about 60 RAP insolvent thrifts in Texas. It seems that FSLIC in Texas is in a more difficult position than Alice in Wonderland, in that FSLIC must run very fast to stay in the same place.

While the announcement of the Southwest Plan claimed that over $1 billion in new capital would be brought into the industry, and that has been accomplished. However, the original expectation was that new private capital would represent 14-16% of the total funds put into resolving these cases, in fact the private investments have amounted to less than 4%. This reflects the fact that the negative net worth hole has turned out to be larger than estimated, and that FSLIC has been unwilling to fill the hole sufficiently to attract large amounts of private capital. The new private capital committed so far (including some to be provided in the future) amounts to little more than 1% of the deposit liabilities assumed.

The arithmetic of such transactions means that the resulting institutions are undercapitalized, with most operating with capital-to-liabilities ratios of 3% or less. The weighted average capital-to-liabilities ratio of the resulting institutions is about 2.1%.[9] Interpreting the resulting capital ratios is somewhat tricky because of the asset composition of these institutions. Virtually all the assets are subject to FSLIC guarantees as to both credit risk and interest rate risk. Usually the acquirer does not even review the assets of the acquired thrifts, but receives a guarantee of earnings on all risk assets. Typically this is pegged to the Texas cost of funds, with a spread that may be as high as 2 3/4%. The acquirer will be protected against loss on sale of these assets, and any profits are shared between the acquirer and FSLIC.[10] It has been argued, particularly by FHLBB Member Larry White, that because of the minimal risk (at least as long as the guarantees are in effect) very little capital is needed.

That argument is well-taken, though it gives rise to two responses: First, if all the risk remains with FSLIC (risk for which it is compensated by a share of earnings and warrants to purchase additional stock), and FSLIC must devote management time to monitoring asset values, why is the private investor needed at all? Why doesn't FSLIC own and operate all these institutions? Second, granted that the risk being borne by the private investors at this time does not require very much capital, do the purchase agreements provide that, as covered assets decline as a share of assets, and new assets are added, new capital is to be put in? While FHLBB officials suggest that the answer to that is affirmative, they have been unwilling to make the details public. Recent Bank Board policy positions on "pre-nuptial agreements" suggest that investors may be able to simply walk away if capital requirements are not met.

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[9] All of these figures on the Southwest Plan are distorted by inclusion of the Sunbelt deal, which does not represent a true case resolution, but only a stabilization. Since no private capital was brought in, and Sunbelt operates with zero capital, all ratios look worse than they would if Sunbelt were excluded.

[10] Sales of any significant amount of such "covered assets" requires the approval of FSLIC. While close monitoring seems to be the rule, FSLIC would seem to have little to fear from potential dumping of assets. The guaranteed spreads, though scheduled to decline over time, remain high enough long enough that some critics believe that the new owners have little incentive to work the assets or sell them at a fair market price. Some view the Southwest Plan as an elaborate means of warehousing real estate to prevent its being dumped on the market. FSLIC does retain some control over the process, as it has the right to purchase the assets at a contractual price.

This approach may well be costly in the long-run. A high-ranking GAO official noted in recent Congressional testimony that "Some mergers have resulted in institutions so poorly capitalized that further costly action may be necessary. For example, four institutions that acquired failed thrifts with FSLIC assistance in 1987 had negative tangible net worth at the end of the year."[11]

The negative aspect of deals that are too thin and result in institutions that are undercapitalized is the effect on incentives. Since the new owners have little capital of their own at stake, there is a strong tendency toward excessive risk-taking. The distorted incentive structure results from the fact that these institutions can obtain insured deposits regardless of the riskiness of the institution's portfolio. If their risky investments pan out, they earn high returns. If their investment results are poor, it is FSLIC that bears most of the loss. This incentive toward risk-taking is not mitigated by FSLIC's retaining an equity participation in future profits. As long as the owners do not have a large capital stake at risk, the incentive structure is distorted.[12] This is not merely a theoretical possibility--it is, after all, how we got into the present crisis. Economically insolvent thrifts were allowed to continue in business in the early 1980's, and many took great risks in order to get back into the black. The general effect on incentives may be exacerbated if these FSLIC deals provide some specific forbearances that encourage or allow risky activities.[13] Of course, these unhappy outcomes will not occur for some time--not until after the current FHLBB management has moved on to greener pastures. This can be viewed as another form of delaying true resolution of cases.

While these deals can be criticized for being too "thin," the real question is whether this approach truly represents the low-cost solution for FSLIC. There is an obvious alternative: liquidation. There appears to be substantial overcapacity in the Texas thrift industry: institutions can survive only by importing large amounts of out-of-area deposits, for which there is no local loan demand. Thus Texas institutions offer higher than national average rates on deposits, and charge lower than national average rates on loans--a sure recipe for less than satisfactory profits. Shrinkage in the industry is clearly called for, but each individual institution sees advantages in growth. The acquirers under the Southwest Plan inherit institutions with high G&A expenses which they are committed to reduce. But they will also be tempted to lower the G&A expense ratio by increasing the denominator. In fact, the FHLBB has, in some cases, encouraged (or at least countenanced) rapid growth as a solution to thrift problems.

Liquidation of unnecessary institutions would be to almost everyone's benefit, and would be cheaper for FSLIC even though it requires larger cash payments up front.[14] It is not difficult to determine which institutions should be liquidated. If FSLIC announces its willingness to bring net worth of an insolvent institution to zero, and seeks buyers who are willing to capitalize it in accord with existing net worth requirements, we have a market test. It is an inefficient use of resources to keep in operation those institutions that cannot promise a fair market return on the required investment.

At one time political pressures were brought to bear to keep all Texas thrifts in operation. That is no longer the case. There are virtually no depositors with over $100,000 at risk. The only logical reason for avoiding massive liquidations in Texas is that FSLIC lacks the cash to take such actions. But part of the reason FSLIC lacks the cash is that the FHLBB has been unwilling to concede that more funds are needed. Until very recently, Chairman Wall argued that enough resources will be available to FSLIC over time to handle the problem. That view precludes large-scale liquidation, because even under the most favorable Wall scenario, not enough funds would be available immediately to cover such liquidation. As long as the public still has confidence in the deposit insurance system, this is a problem that can be put off indefinitely. Resolution cannot be delayed indefinitely without a higher cost, however.

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[11] Frederick Wolf, Senate Banking Committee, 1988. This type of outcome is not inevitable, however. Earlier this year FSLIC assisted the acquisition of Eureka Federal, a $1.7 billion California institution, by America First Financial. In that transaction, America First put up $100 million of new capital, approximately 6% of liabilities. FSLIC had to put up $291 million cash, but the result is a well-capitalized thrift that should be permanently eliminated as a source of concern to FSLIC. Of course, the $100 million of private capital could not have been enticed into acquisition of a troubled thrift unless FSLIC completely filled the net worth hole.

[12] This effect is avoided if the deal is so sweet that the acquirer will not take risks that may result in losing control. Some have suggested that the early Southwest Plan deals were "loss leaders" in this respect, attempting to arouse additional interest among potential bidders.

[13] Much attention has been given to the deal for FCA with the Bass Brothers, which allows them to use a significant amount of funds of the recapitalized American Savings for merchant banking activities that would not otherwise be legal for a savings and loan. The California Savings & Loan Commissioner refused to grant a charter for an institution with such operating powers. One of the purchasers under the Southwest Plan is Pulte Diversified, Inc., a large home-building firm. Normally, a thrift controlled by such a firm would not be allowed to make loans to buyers of houses built by the firm. It has been rumored that Pulte has specific permission to make such loans. It must be recognized that some combination of the thrift with profitable activities is necessary if the tax benefits are to be utilized.

[14] FSLIC must consider liquidation and can only provide assistance for an acquisition when it concludes that such a deal is cheaper than liquidation. FSLIC does not provide information on this comparison. It is possible that the comparison is biased by its treatment of goodwill or tax benefits. In any case, it seems to ignore the benefits to other assisted institutions of removing some insolvent shops from the market. It may be appropriate to ignore this consideration if only one or two institutions are receiving FSLIC assistance, but if much of the industry is involved it is wrong to ignore the potential benefits to the surviving S&Ls of closing down others.

The Southwest Plan has apparently been successful in meeting some of its objectives. It appears that the "Texas premium" has been substantially reduced.[15] That may be due primarily to the imaginative means by which funds have been channeled to weak institutions in order to keep them from bidding for deposits, rather than to the Southwest Plan. These include the "As Agent" program of the Federal Home Loan Bank System, and the tremendous increase in advances made by the Federal Home Loan Bank of Dallas. As noted earlier, the Southwest Plan acquisitions facilitate the increasu in advances, as institutions with collateral to secure advances were combined with thrifts without any remaining collateral.

There has also been some success in reducing operating expenses, though it is probably too early to judge the magnitude of the savings. Southwest Savings, one of the earliest Southwest Plan acquirers, has made substantial reductions in its combined costs. Branches have been reduced from 109 to 75, with several additional closings scheduled for early next year. Southwest's 1989 budget projects a $40 million reduction in operating expenses, bringing G&A expenses from 2.24% of assets in 1987 to 1.13% in 1989. Other institutions have made comparable progress in closing branches. FSLIC has generally been successful in putting together packages of institutions with overlapping branch structures that facilitate such closings, though it has abandoned its earlier attempts to combine institutions with compatible data processing systems.

The Southwest Plan, conceding its benefits, must be seen primarily as a vehicle for delaying solutions. From all that can be known at this point, it appears that FSLIC has selected highly-regarded buyers. Managers, even when coming from insolvent shops, are those who have excellent individual reputations. My criticism is not of the morality or capability of the people involved in Southwest Plan acquisitions. The shortcomings of the plan relate to the financial structure and the fact that even individuals of high character and capacity respond to incentives. The low capitalization of the resulting institutions may be incentive-incompatible with a federal deposit insurance system. FSLIC funds should not go toward keeping in business institutions that cannot meet normal net worth requirements.

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[15] It is difficult to measure the extent of the Texas premium. What is clear is that the well-publicized lists of the highest-rate-paying institutions in the country, once comprised almost totally of Texas thrifts, now include few Texas institutions.

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Statement No. 38

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Statement of the Shadow Financial Regulatory Committee
on
An Outline of A Program for Deposit Insurance Reform

December 5, 1988

Successful deposit insurance reform requires that: (1) existing losses in the system need to be recognized as governmental liabilities and necessary steps taken to keep these losses from becoming larger, (2) the current regulatory and supervisory system needs to be reformed to correct the incentive problems and structural defects in the present system, (3) an acceptable phase-in period be adopted so that institutions will have time to adjust to the new regime, and (4) a method be devised to pay for the real but unrecorded losses in existing depository institutions.

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The following proposal seeks to remedy the current flaws in the present system and to manage the transition from the present to a new system. They embody capital adequacy policies, increased monitoring of asset values, timely reorganization before a depository institution's economic capital is exhausted, increased market incentives and rigorous supervisory enforcement as the foundations for new supervisory and financial regulatory policies that will be consistent with an efficient financial system, which is equitable and safe. The following are the major components of the proposal:

CAPITAL POLICY

Establish four ranges or tranches of capital-to-asset ratios with differing supervisory policies applicable to each tranche as follows:

1. Tranche 1 - ADEQUATE CAPITAL (e.g., 10% of assets or greater) -- banks with capital above this minimum amount would be subject to "normal" (i.e., minimal) regulation and supervision.

2. Tranche 2 - FIRST LEVEL OF SUPERVISORY CONCERN (e.g., 6-9.9% of assets) -- once a depository institution's capital ratio falls into this range it

will be subject to increased regulatory supervision and more frequent monitoring of its activities. The supervisory authority will have the discretion to require the institution: (a) to submit a plan to raise sufficient capital to the entry level for Tranche 1, (b) to suspend dividend payments and/or up or downstream payments within a holding company system, and (c) to restrict permissible asset growth.

3. Tranche 3 - SECOND LEVEL OF SUPERVISORY CONCERN (e.g., 3-5.9% of assets) -- when an institution's capital ratio falls into this range, it will be subject to intense regulatory supervision and monitoring. Suspension of dividends, interest payments on subordinated debt and outflows of funds to an institution's parent or affiliates will be mandated. Prohibitions on asset growth will be used to prevent institutions from attempting to "grow" out of their problems. Finally, an institution will be required to submit an emergency plan for its recapitalization to be implemented in the event it falls into Tranche 4.

4. Tranche 4 - MANDATORY RECAPITALIZATION AND REORGANIZATION (less than 3% of assets) -- The federal deposit insurance agency will place the institution in a mandatory conservatorship. This conservatorship would

be charged with recapitalizing the institution or liquidating it in an orderly fashion within a short period of time by merger, or by sale of either the entire organization or its individual assets. Present owners will have the option of implementing the plan submitted when the institution moved into Tranche 3, or electing not to inject further funds into the institution. Following final disposition of the firm's assets, any residual value will be returned to subordinated debtholders and shareholders, after allowing for any costs incurred.

KEY CLARIFICATIONS AND FEATURES OF THE PROPOSED STRUCTURE

1. DEFINITION OF CAPITAL -- Capital should be defined as the difference between the market value of assets and the market value of liabilities other than subordinated debt.

2. SUPERVISION COSTS -- Charges for supervision, regulation, examination and monitoring would be paid for by depository institutions. Because examination and monitoring effort increases as an institution's capital declines, these charges would increase as capital

declines, so that charges function as form of risk-adjusted insurance premium.

3. CHARTER SHIFTING -- Institutions are still permitted to change their regulatory agency within the new structure. This contributes an incentive for the respective agencies to balance the costs and benefits of supervision and to limit overzealous supervision.

4. ACCOUNTABILITY OF SUPERVISORS -- Supervisors will report to Congress yearly on the institutions in each tranche and on the actions taken to restore institutions to Tranche 1.

Supervisors will be responsible for assuring that the recapitalization plans are acted upon. Periodic GAO audits, annual reports and regular congressional oversight will provide an element of discipline for the regulators.

5. REGULATORY RESPONSIBILITY IN TRANCHE 4 -- The appropriate insurance agency will be notified when an institution moves into Tranche 3 and will receive all supervisory reports, etc. in anticipation of having to take the institution over if it moves into Tranche 4.

6. CREATION OF SUPERVISORY AUDIT TRAIL -- Use of tranches and required consultations will document regulatory problems encountered in attempting to value firms as they moved through the tranches. This should simplify resolution of valuation controversies should an institution be forced into recapitalization or reorganization.

7. INSURANCE PREMIUMS -- Explicit charges for insurance should be low under this system since theoretically only fraud cases and abnormal market movements would involve significant risks to the insurance funds.

8. HOLDING COMPANIES AND PERMISSIBLE ACTIVITIES -- Neither the wisdom of the present holding company structure nor the logic of the activity restrictions that now exist under the current regulatory structure is addressed in this proposal. Resolution of these issues, while important, is a separable issue.

9. INSURANCE COVERAGE -- Present deposit insurance coverage of $ 100,000 per insured account need not be changed for the proposal to be effective.

10. MARKET VALUE ACCOUNTING -- The reorganization rules should be based on market values to minimize risks to the insurance funds and to allow both the regulators and banks to take informed actions in a timely fashion.

11. DISCLOSURE -- The reports embodying the market values of institutions should be publicly available. This will enable the Congress and public to monitor better the financial condition of banks and the performance of the supervisory agencies.

12. LARGE BANK FAILURES - All institutions that fall into Tranche 4 should be reorganized or allowed to "fail" regardless of their size and pro-rata losses charged to uninsured creditors. "Failure" means reorganization and change of ownership and does not necessarily imply a disruption of borrower or depositor relationships. Any other policy would present unacceptable incentive problems, provide inequitable treatment and foster unfair competition.

TRANSITION

Except for institutions with zero (or less) GAAP net worth, there should be a transition period for the new capital tranches and regulatory policies that might be as long as 5 years. Unless they are recapitalized, GAAP-insolvent institutions should not be kept afloat.

DEALING WITH EXISTING LOSSES IN THE SYSTEM

Dealing effectively with existing losses in the system requires first, that they be explicitly recognized as liabilities of the government rather than merely of the insurance funds; second, that insolvent institutions be either recapitalized and/or reorganized, merged, sold or liquidated; third, that a method be devised to finance the costs associated with closing these institutions which entails direct use of U.S. government credit;[1] and fourth, that methods be devised for prompt disposal of assets acquired during reorganization of insolvent institutions.

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[1] Any financing method not based upon the full faith and credit of the U.S. government will necessarily be more expensive and, given the magnitude of the existing problem, inappropriate. A straightforward approach in the context of the present system would be for the insurance agencies to turn their funds over to the Treasury and to meet deposit insurance obligations by drawing checks on the Treasury.

Exhibit 1

"TWO INDUSTRIES": COMPARISON OF THRIFTS BY NET WORTH CATEGORIES 1988 (END OF 2ND Q)

$ Billions, percentage

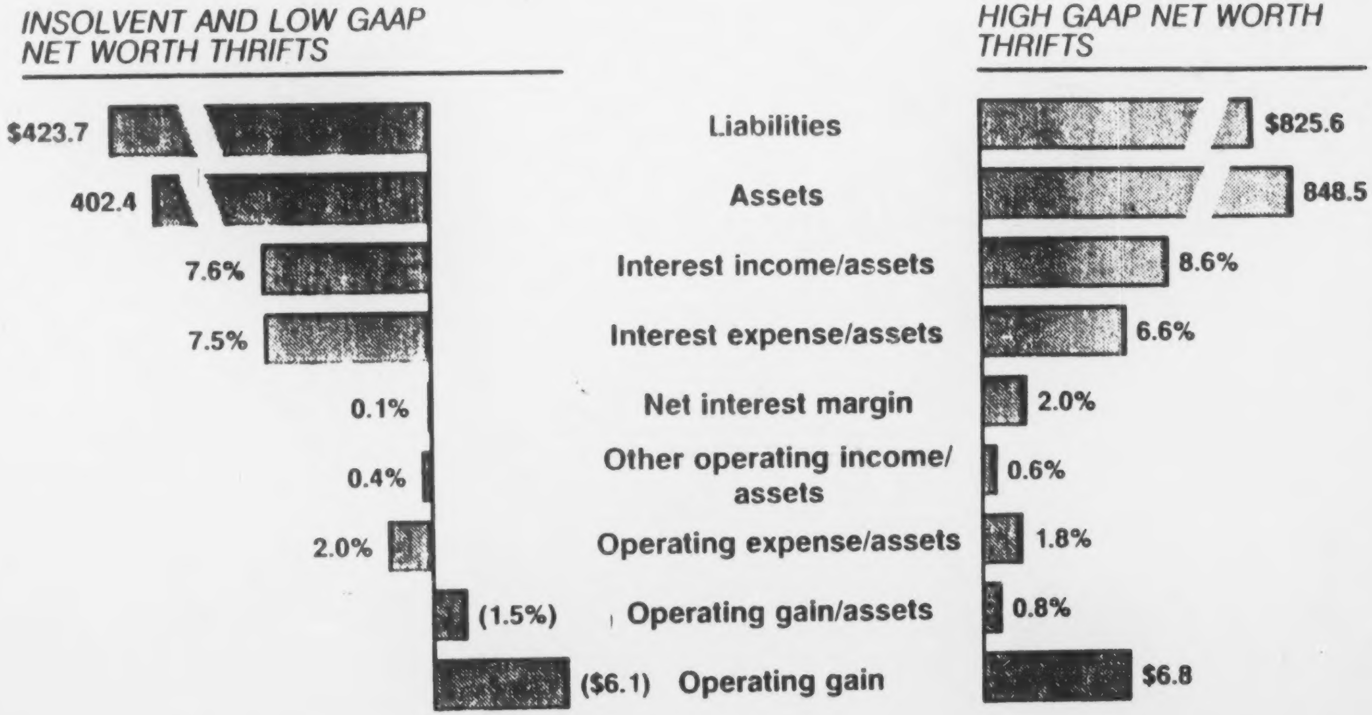


Exhibit 2

EVOLUTION OF LIABILITIES OF HEALTHY AND UNHEALTHY THRIFTS 1986-88 (End of 2nd Q)

$ Billions, percentage

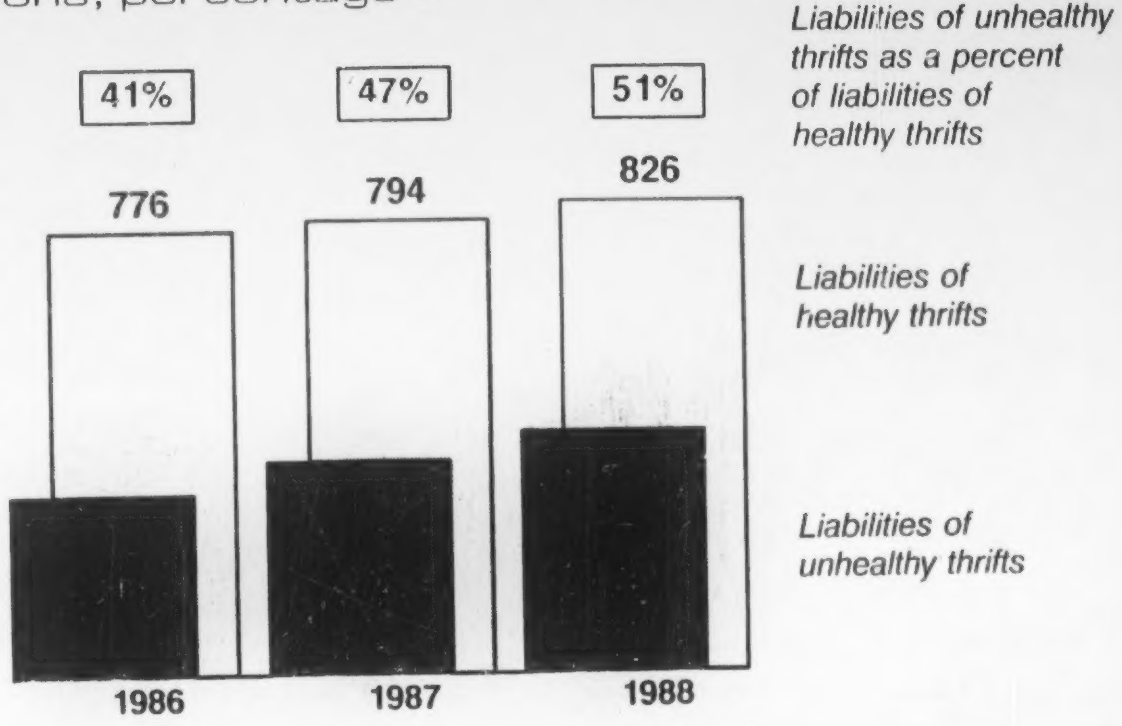


Exhibit 3

STRUCTURE OF A COMMERCIAL REAL ESTATE LOAN

ILLUSTRATIVE

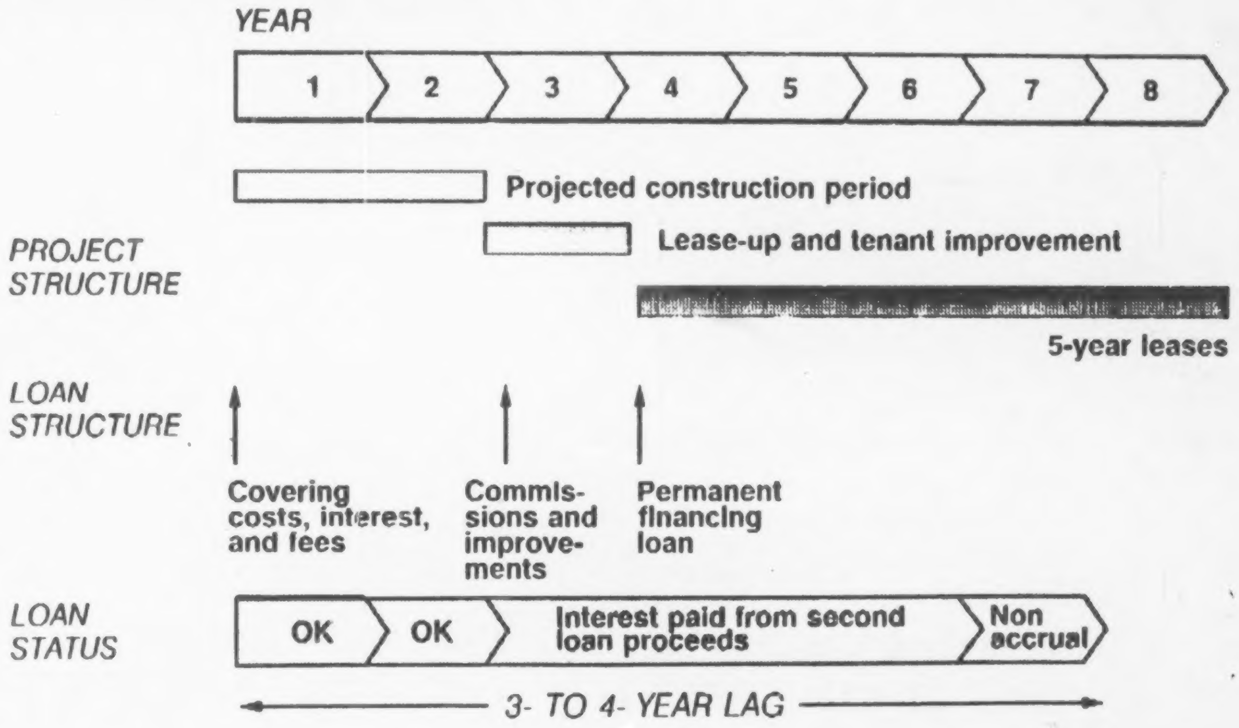

YEAR
1
2
3
4
5
6
7
8
PROJECT STRUCTURE
Projected construction period
Lease-up and tenant improvement
5-year leases
LOAN STRUCTURE
Covering costs, interest, and fees
Commissions and improvements
Permanent financing loan
LOAN STATUS
OK
OK
Interest paid from second loan proceeds
Non accrual
3- TO 4- YEAR LAG

Exhibit 4

LAGS IN QUALITY ASSESSMENT OF COMMERCIAL REAL ESTATE LOANS

ILLUSTRATIVE

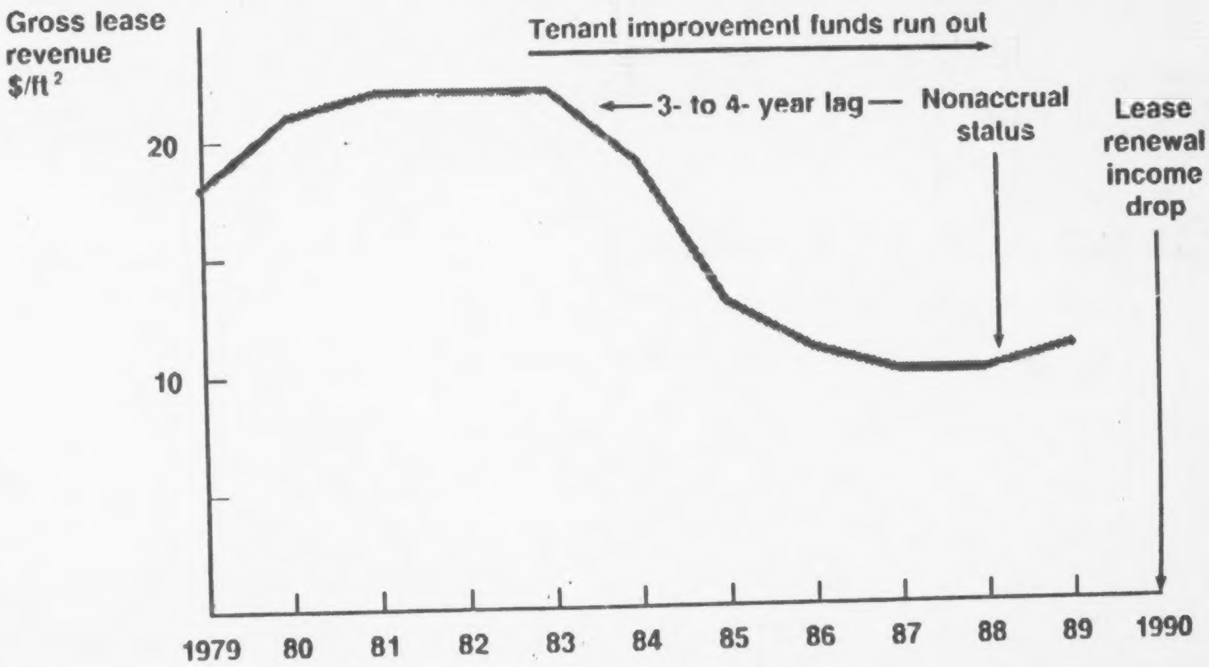


Exhibit 5

64 MERGED/ACQUIRED THRIFTS VS. NEGATIVE AND LOW GAAP NET WORTH THRIFTS: FINANCIAL RESULTS BEFORE MERGERS 1988

$ Billions

BALANCE SHEET

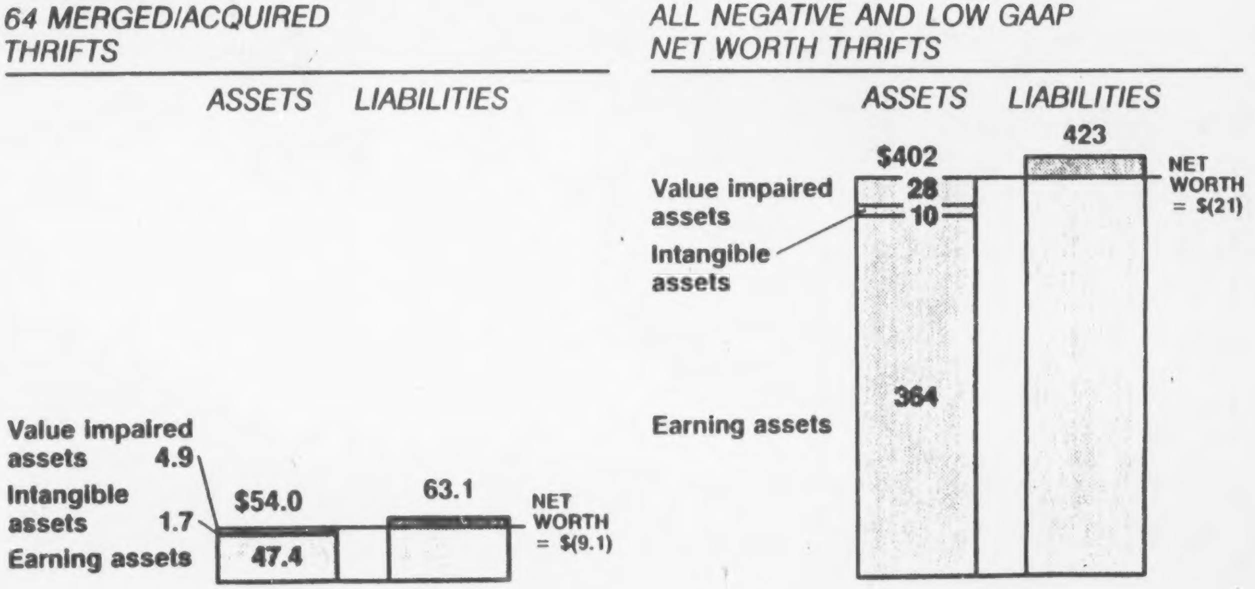
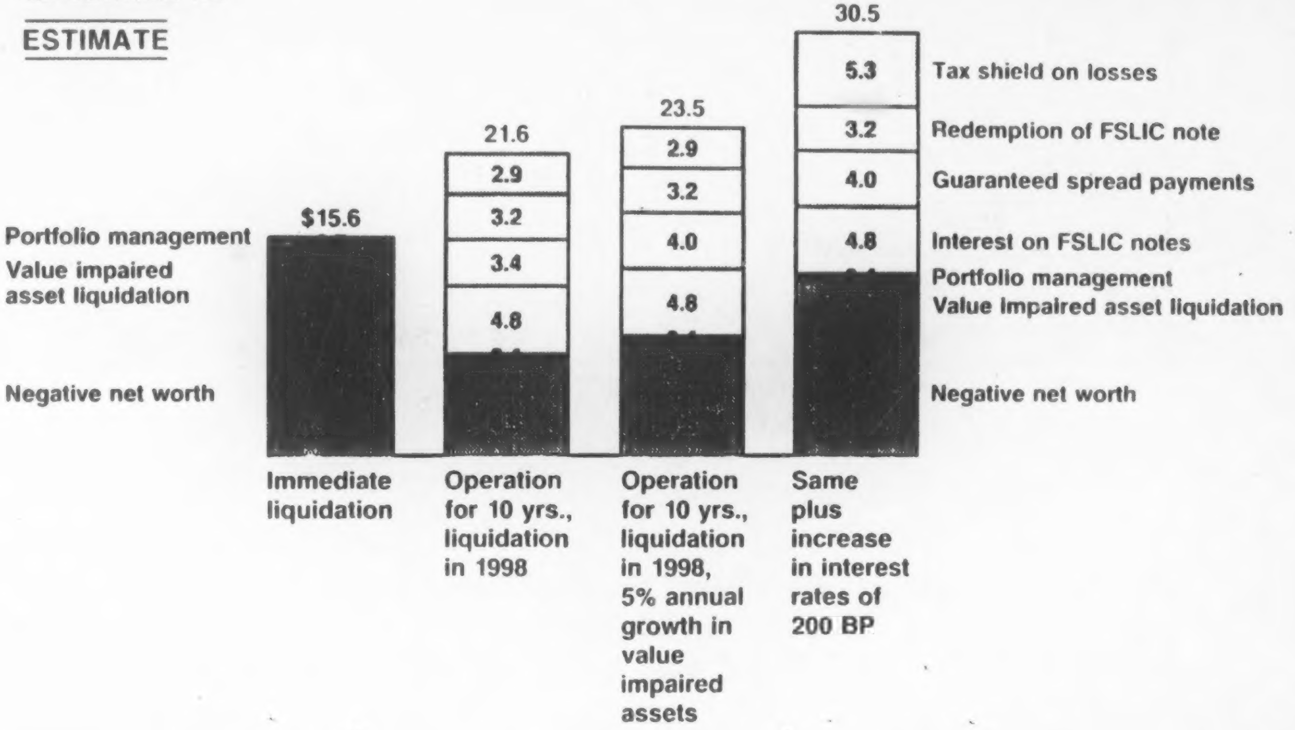


Exhibit 6

63 MERGED/ACQUIRED THRIFTS: PROJECTED COST OF LIQUIDATION TO THE GOVERNMENT

$ Billions

ESTIMATE



APPENDIX

EXHIBIT 1

The thrift industry can actually be separated into two very different categories of institutions; high net worth thrifts which are generally strong financially and have viable franchises, and negative and low net worth thrifts which are characterized by high cost of funds, low return on assets, negative net interest margins, higher operating costs and significant pre tax net operating losses.

EXHIBIT 2

Liabilities of negative GAAP net worth thrifts, and low GAAP net worth thrifts (those with GAAP net worth that is positive but less than 3 percent of assets) have increased at an annual rate of 29 percent between December 1987 and June 1988. The highest growth rate has been in the negative net worth category, where liabilities grew at an annual rate of more than 101 percent over the period.

The increase in liabilities was the result of a combination of new, larger institutions entering this category as smaller institutions exited, and of the growth of institutions in the category.

This growth has been compounded by the accumulation of net operating losses and the consequent growth in negative net worth. As of June 1988, liabilities of negative and low GAAP net worth thrifts amounted to 51 percent of the liabilities of the high GAAP net worth (greater than 3 percent of assets) thrifts, up from 41 percent in December 1986.

EXHIBIT 3

Construction financing is generally structured in two tranches. The construction tranche, which is disbursed initially, covers construction costs and interest costs for a period of about 2 years and accounts for roughly 75 percent of the financing. The lease-up and tenant improvement tranche, which is disbursed at the end of the construction period, covers building improvement and preparation and accounts for about 25 percent of the financing.

Thus, even if a project is clearly in trouble because of a drop in lease prices at the end of the construction period, the loan could still be kept on accrual for about 3 years if the bank disburses the second tranche which the borrower then uses for servicing the debt, rather than for lease-up or tenant improvement.

EXHIBIT 4

Given the large drop in Texas commercial real estate leases that took place between 1983 and the present, many of the currently untroubled permanent financing loans on the books of thrifts, which are backed by 5 year leases contracted in 1983 and 1984, could turn sour when the leases expire in 1988 and 1989.

Because these loans are usually structured with a safety margin of about 25 percent, it is thus possible that the asset quality of Texas thrifts will continue to deteriorate even if the Texas market starts to recover this year.

EXHIBIT 5

The 64 merged/acquired thrifts that the FHLBB has consolidated since August had, as of June 1988, total assets of $54 billion (or about 13 percent of total assets of unhealthy thrifts). We estimate that they have about $4.9 billion in value impaired assets (or about 18 percent of total value impaired assets of unhealthy thrifts).

EXHIBIT 6

This exhibit shows the estimated net present value cost to the Government of liquidating the 63 thrifts versus projected net present value cost to the Government of continuing to operate them under the Bank Board consolidation plan, based on publicly available information on the deals.

The first bar shows the cost of immediate liquidation, assuming no recovery of value impaired assets, including $14.9 billion to cover the current difference between liabilities and earning assets and $700 million to manage the orderly liquidation of earning assets over a period of 10 years.

The second bar shows the net present value cost to the Government of operating the thrifts for 10 years and then liquidating them, including the cost of covering the excess of liabilities over earning assets, the portfolio management cost, the total cost of interest payments on the FSLIC notes and of guaranteed spread payments, the cost of redeeming the FSLIC notes at the time of liquidation and the tax revenue foregone on operating losses.

The third bar shows the same costs assuming a 5 percent annual deterioration in asset quality and the fourth bar shows the cost assuming, in addition, a 200 basis point increase in interest rates.

The **Chairman**. Thank you very much.

We will start with 5-minute question sessions so we can move back and forth.

Mr. Bryan, you just heard Dr. Horvitz and he, I think, takes quite a different view than you do. In terms of the critical differences, I hear him saying "Put the money in now, do the regulatory rearrangements that may be needed a little later on down the line when you get at them"—I'm paraphrasing. And I also hear Dr. Horvitz saying that while he's not all that enthusiastic about the Southwest plan, presumably it will hold together and we're not likely to see this whole problem come back around again in the same size or a larger size in the future.

I hear you expressing I thought quite a different view. Now I'd like you to comment on his point of view and if you disagree why you disagree.

Mr. **Bryan**. Well, I'm sympathetic with the notion of let's pay the money now and deal with the reform issue. I think we need the money now.

I've got to say the history of financial regulation and legislation over the last 8 years shows that that is impossible. The truth is, every time you allow the narrow self-interests of the various parties to interact you wind up with legislative gridlock. Only when you have sufficient national will can you deal with deposit insurance reform. And I really think that this is the moment for seizing the opportunity because I really do not think it will happen otherwise. I think if you pass one bill now and give them money, it will be postponed for 2 years and then we'll be back having to deal with it again only it will cost ever more money.

Second, whether or not this is a one-time problem or a systemic problem, I think I've been fairly clear that I think that the fundamental underpinnings of the problem are still there, that dealing with these problem institutions is a necessary but not sufficient step and that systemic unsound risk taking is still going on I believe, that whenever an unsound depository winds up having trouble generating enough operating earnings, the first thing it does is begin to use more liberal accounting practices and the second thing it does is it takes more risk.

And we do not know how bad the problem is now. I do know I've worked a lot on the inside of financial institutions and know the degrees of freedom that management has to both deal with accounting issues and to take more risks. And under pressure to produce results, they will always take more risks.

The **Chairman**. Now you made a couple of points that I thought were powerful. One, you said that if market forces alone had been at work back in the last few years in terms of a lot of the savings and loan investments, that investor capital out of a free capital market system would not have been put at the kind of risk that we see happened here. It was only because the Federal deposit insurance was there that it caused the dollars to move into such risky ventures.

I'm struck by that. I wanted to highlight that because it's another way of saying that people, if they were putting their own money at risk, would have preferred and would have chosen to do other things with it rather invest in the profile of risks that the

FSLIC is now responsible for. But you made a point following on from that where you began to cross-connect the problem in the savings and loan system as you see it with the commercial banking system and then you said that if we were to find ourselves in the future facing economic shocks, interest rate spike situations, or a downturn in the economy, you were concerned that this problem in a sense could come across to affect the banking system and that we might have the potential for a structural breakdown of a far larger size. I'd like you to elaborate a little more on that.

Mr. BRYAN. The commercial bank industry has charged off $60 billion in the last 4 years. From 1948 to 1981, the entire industry charged off $28 billion. That's twice as much in 4 years as in a previous 33-year period.

What I'm saying is there's another part of the history, which is, whenever you have a recession charge-offs in the industry double and whenever they double they are also concentrated. Twenty percent of the industry winds up with 55 percent of the charge-offs. So it does not take much of a projection to see that if we have just an ordinary recession we could wind up exhausting the FDIC funds. So I think the issues are very heavily linked. I think we really need to address deposit insurance reform, not narrowly but broadly.

Now in the paper I was suggesting we go to one insurance fund and that we use FSLIC basically as a work-out fund to work out the problems while the institutions are being liquidated and that we use the FDIC as a true insurance fund where the industry would be responsible for putting up premiums to keep the system solvent. That's why I really believe you should not take the existing ability of healthy institutions to pay premiums to bail out the old problem. I think that money is going to be needed to protect the system in the future.

FINANCIAL AS WELL AS STRUCTURAL CHANGES

The CHAIRMAN. Mr. Carron, let me ask you, your bottom line on the degree to which it's important to connect the financial side of the problem, putting the money in as it's obviously now needed with the need for major structural overhaul, could we do these things separate and apart spread over time, or do you think they have got to be patched together?

Mr. CARRON. I think operationally they could be done at different times. I don't think that we will in the very short run slide into another hole like this. I wouldn't want to comment on the political feasibility of doing them separately versus doing them together. I worked in this building at one time myself and I understand that one can often take something that is popular and ally it with something that is useful and that is good and thereby achieve two objectives at the same time.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you very much.

One conclusion that you all seem to come to is that it is far better to liquidate insolvent thrifts than to do some of the things that the Federal Home Loan Bank Board was forced to do.

Are there any situations where liquidation would not be most cost-effective or is it always cost-effective, Mr. Bryan?

IS IT COST-EFFECTIVE TO LIQUIDATE PROBLEM INSTITUTIONS?

Mr. BRYAN. It is always cost-effective to restructure an institution if there is franchise value there that someone is willing to pay for. To be able to do that, though, you need to know what the Government's maximum risk is. For example, in the FDIC First Republic transaction with NCNB, the Government's extent of their risk was pegged and therefore you could actuarially calculate their liquidation versus the keeping it open point of view.

In the deals in the Southwest plan, the risk is unlimited to the Government. All downside risks were absorbed by the Government, interest rate risks, everything.

Senator HEINZ. I understand that.

Mr. BRYAN. The real distinction is whether or not you can compare the liquidation costs against a known cost of the resolution and that has to be in that case cheaper.

Senator HEINZ. How do you analyze that cost under those circumstances when you cannot figure out the true value of a real estate project. For example, in Houston, in Mr. Horvitz' area, there may be a huge condominium standing there that is beautifully built but is costing lots of money to maintain. It may be worth a fortune 10 years from now if it's still standing. How do you compare the liquidation and resolution costs under those circumstances?

Mr. BRYAN. Very easily. You take the collateral away from the institution and your portfolio manage it and you give incentive clauses to work it out expeditiously so you don't dump it on the market.

Senator HEINZ. I didn't say how you manage it. I said how do you value it?

Mr. BRYAN. How do you value it?

Senator HEINZ. Yes. I would like to understand how you decide when liquidation is the least cost strategy.

Mr. BRYAN. The value of the building doesn't change. If you own it as the Government it doesn't change. The point is, if you liquidate the institution you save the premium paid by the institution——

Senator HEINZ. Maybe I misunderstood. Are you saying that it is in fact always cheapest to liquidate?

Mr. BRYAN. It is always cheaper to liquidate if the institution has no franchise value that someone is willing to pay for it.

Senator HEINZ. You mean when you cannot evaluate the value of the assets?

Mr. BRYAN. Right.

Senator HEINZ. Is there any disagreement with that?

Mr. HORVITZ. Yes. I think liquidation is infrequently the appropriate solution. Where I suggest FSLIC should liquidate some institutions, there are some institutions in Texas with absolutely no franchise value. It would be beneficial to liquidate those institutions. That is, close the institution and pay off the depositors.

Most of the institutions in Texas that are in difficulty do have franchise value. They do have local deposits, core deposits, and restructured, refinanced, recapitalized they can be profitable in the future. But there are some institutions that should be liquidated. The problem FSLIC has in that it doesn't have the cash to do the liquidation in those cases where they should be liquidated.

Senator HEINZ. Mr. Horvitz, let me ask you a different question. Are there any healthy S&L's in Texas?

Mr. HORVITZ. There are a number of smaller savings and loans that are healthy. There are relatively few large institutions that are healthy, but there are some.

Senator HEINZ. Do you know of any healthy S&L's in the Southwest that are large?

Mr. HORVITZ. Yes.

Senator HEINZ. Name one.

Mr. HORVITZ. Well, Guardian in Houston is a healthy institution. In part that may reflect the fact that it doesn't do a traditional savings and loan business.

Senator HEINZ. Is it a mutual association or a stock corporation?

Mr. HORVITZ. It's a stock institution.

Senator HEINZ. Is the stock publicly traded?

Mr. HORVITZ. I don't believe so.

Senator HEINZ. Have you any idea of what the market value of the equity of that savings and loan would be worth?

Mr. HORVITZ. No, I don't.

Senator HEINZ. Does anybody have any idea as to what the market value of any known healthy savings and loan of sufficient size is?

Mr. BRYAN. The west coast thrifts are reasonably profitable and have market values close to book value. They have very high return on equity. One of the significant problems they have is the cloud over the industry which has caused discounting of their valuation.

Senator HEINZ. If we remove the current cloud over the industry would the equity portion of the S&L rise above the book value?

Mr. BRYAN. For a very few institutions.

Senator HEINZ. I'm talking about over time, over the next 5 to 10 years. Is there any prospect that if we do the right thing tomorrow—and obviously we haven't quite worked that out—that 5 or 10 years from now there will be healthy S&L's whose market value will be in excess of their book value?

Mr. BRYAN. The healthy ⅓ of the industry may well be able to do it, but I agree with Mr. Carron they may not look much like traditional S&L's, but there's ⅓ of the industry that's pretty well run.

Senator HEINZ. If you accept the principle, and it's a political decision the committee is yet to make that we will insist on reform before we pass anything, what are the most important two reforms—I'll limit it to two—that we could make in order to prevent a recurrence of the problem?

Mr. Carron, I haven't asked you.

Mr. CARRON. I think current value reporting—or mark-to-market accounting—and a strict closure rule.

Senator HEINZ. Mr. Bryan.

Mr. **Bryan**. I think liquidating hopelessly insolvent institutions——

Senator **Heinz**. No, I'm talking about reform.

Mr. **Bryan**. With deposit insurance reform you'd be going basically to a single deposit insured entity, essentially FDIC, which would become the insurance fund for all deposit insured. It would be the No. 1 reform.

The second would be to limit risk taking of institutions that don't meet capital standards.

Senator **Heinz**. Mr. Horvitz.

Mr. **Horvitz**. I would agree with Mr. Carron. Closing and market value reporting and perhaps I would add a high capital requirement. But I might note that that doesn't necessarily require any action by the Congress. Those changes pretty much can be brought about by action by the regulatory agencies themselves. The recent net worth proposals of the Federal Home Loan Bank Board go a long way toward the kind of reforms that we have said are essential.

Senator **Heinz**. Thank you.

The **Chairman**. Senator Cranston.

Senator **Cranston**. Apparently no one knows exactly how much the ongoing costs are as long as we fail to achieve a resolution of this problem. Estimates run from $½ a billion to a $1½ billion a month from run-off of insolvent thrifts that can't be closed because of the lack of funds to liquidate them.

And there's a difference of opinion obviously in this committee as to whether we have to tackle the whole thing at once or whether we should at least take some steps to stop the hemorrhaging as rapidly as we can.

If it would take us until September or October to resolve the matter, we could be increasing the total ultimate bill by as much as $10 billion. I think we have to consider what steps might be appropriate swiftly.

Do you have any estimates—and I ask this of all of you—of how much money is needed right now to create the capacity to stop the ongoing everincreasing total bill? You don't need the full $100 billion.

CASH THAT IS NEEDED NOW

Mr. **Horvitz**. You don't need the full $100 billion, but you need a very sizable amount. A piddling out of the amounts on the order of $7 billion or $10 billion a year is not appropriate and is not adequate.

Senator **Cranston**. Can you make any estimate of what is needed?

Mr. **Horvitz**. Well, the FSLIC dealt with the Texas Southwest plan deals at an estimated cost something like $25 billion and still leaves a substantial amount to be done. I think we are talking about money that is needed and could be used quickly is on the order of $25 billion plus.

Mr. **Bryan**. I think $35 billion to $40 billion is a good range—$50 billion. I think the fundamental cash flow problem is not really appreciated. You've got $420 billion of liabilities in these institutions.

They have $420 billion flown out the door and they only probably have $25 billion of real income coming in—maybe $30 billion of real income. You've got a $10 billion to $15 billion cash flow problem that has to be plugged with cash. Whether the Government guarantees that cash flow problem, it still exists and that's what the cash is needed for to somehow plug that cash flow problem.

Senator CRANSTON. Mr. Carron, do you have any notion?

Mr. CARRON. I have not looked at the research to come up with an independent estimate of the cost.

Senator CRANSTON. Are there any other immediate actions other than providing money that could help stem this red tide until funds are forthcoming for liquidation?

Mr. HORVITZ. Yes. Full faith and credit backing for FSLIC notes is something that is relatively easy to do and would certainly be very helpful. That is something that I would urge be done quickly.

Senator CRANSTON. How helpful will that be without producing cash at the same time?

Mr. HORVITZ. Well, that would make it cheaper for FSLIC to do deals by issuing notes. Now the notes are accepted by acquirers with some doubts, some reservations and some discount. It would make it more feasible to do deals at a lower interest rate associated with those notes and the resistance of some of the Federal Home Loan Banks to make advances collateralized by those notes would disappear if the notes were full faith and credit obligations of the U.S. Government.

Senator CRANSTON. Could that be done by the executive branch on its own or is congressional action required?

Mr. HORVITZ. I have no idea, Senator.

Mr. BRYAN. I think it's also important to stop the Southwest plan transactions. I think that they really will make the problem much more difficult to solve in the long run. They have an economically greater cost to the Government if you include tax benefits and, what's more, they basically perpetuate overcapacity in the industry which is the fundamental problem.

Senator CRANSTON. Are there any other steps that can be taken now?

Mr. CARRON. I would add to what Professor Horvitz said, full faith and credit explicitly, legislatively for deposits up to the insured maximum.

Senator CRANSTON. There's been I think pretty universal agreement that higher capital standards are needed to reduce risks, but merely endorsing that solution obviously doesn't produce the capital. Capital is not produced by fiat.

How do we bring more capital into the thrift industry and how do we ensure that the effectiveness of higher capital standards at a time when many institutions will not be able to meet these standards immediately is achieved.

Mr. BRYAN. I think that the basic problem is that many of these institutions are no longer economically viable. Therefore, they cannot retain capital and therefore they cannot attract new equity. If you simply keep them in the system, which is what you're doing by perpetuating their capacity, you will never get the capital you want. The better institutions are already very well capitalized. The problem is that the risks are in the weakly capitalized institutions.

Senator **CRANSTON**. And there is no real way to get new capital into those institutions.

Mr. **BRYAN**. I don't know any private investor that would want to do it.

The **CHAIRMAN**. Well, we sort of did that in some of these deals at year's end, but as you say we hung out tax credits and various other things to create an incentive.

Mr. **BRYAN**. In most of the deals there was no real capital in there at all. It was basically the capitalized value of the tax breaks. So there's no money at risk.

The **CHAIRMAN**. Excuse me. Thank you for yielding.

Senator **CRANSTON**. My time had expired.

The **CHAIRMAN**. Senator Pressler.

Senator **PRESSLER**. Let me just ask one brief question and I have some other written questions to Mr. Bryan.

That is his statement that you don't believe the costs of maintaining a separate regulated thrift industry are worth the costs. What are you saying there in terms of what we should be doing here?

NO NEED FOR TWO COMPETING INSURANCE FUNDS

Mr. **BRYAN**. I think it no longer makes sense to have two competing insurance funds with basically the same deposit insurance. The current system bases competition based upon rules. Everybody knows the savings and loan industry has had a much more greatly expanded charter, has been much more liberally able to take risk, and I don't think you should perpetuate that. I think that that is one of the fundamental causes of the breakdown. I think we need one insurance fund eventually. It's going to take us a few years to get to it—and one regulator. That way we can then put all our eggs in one basket and nurture it carefully and make sure that it remains safe.

Senator **PRESSLER**. And I see we've lost the benefit, as Mr. Carron pointed out, for nurturing housing which was the original mandate for having a separate industry. I think there's a lot of clear thinking in your report. Was this prepared for a client or was this prepared as a public service?

Mr. **BRYAN**. This was self-funded. I was given roughly a year off from my firm about 2½ years ago to look at the credit problems. We produced this report as a public service. It's my own opinion but it's funded by my firm.

Senator **PRESSLER**. Back in the old days we had to account for every hour and charge it to a client.

Mr. **BRYAN**. This was charged to a nonclient account.

The **CHAIRMAN**. Senator Pressler?

Senator **PRESSLER**. Thank you.

The **CHAIRMAN**. Senator Wirth.

Senator **WIRTH**. Thank you very much, Mr. Chairman.

Mr. Bryan, I want to add my commendation to you and McKinsey for this report. I think it is the clearest and bluntest statement of the problem and analysis and set of recommendations that I have yet seen.

I was wondering, Mr. Chairman, as a way of sort of engaging the debate and focusing the issues a little more sharply if it might be possible for us as a committee to send this to the Federal Home Loan Bank Board and ask them to respond to it in writing. It seems to me that this really focuses so many of the issues that we've been talking about from the process undertaken in the so-called Southwest plan, discussions of other options that are available, the cost issues and some of the long-term implications that it might be useful to us to have them respond directly to this, as I think this would tend to sharpen these issues. Perhaps we might consider that, Mr. Chairman, and get Danny Wall and company to respond. I just think that this is such a good piece of work and having read a lot of material in the area I just use this as a way again of commending you, Mr. Bryan.

Let me ask if you might for a minute expand on a couple of issues. One, the insurance issue that you raised in the top of page 14, and second the issue of what's going to happen in some of these troubled areas with existing assets.

Could you comment for a minute or two a little bit further and expand a little bit more on what you mean at the top of page 14 on the Government has been absorbing risks that should be borne by the marketplace? As I noted in my opening comments, I tend to agree with that and I think Senator Graham and I had attempted to get at some of that problem in the legislation we introduced last year.

Would you like to talk a little bit more about that?

Mr. BRYAN. Well, as I said briefly in my opening statement, when you don't have market discipline on the deposit side and you create unlimited opportunity to raise funds for any institution with a charter, you are inevitably going to find the least competent institution is going to be taking the most risk because they are not good enough to understand the risks but they have unlimited access to funds. So you wind up taking the risks and then because they don't have the capital or the management the losses will automatically then go to the insurance fund. So basically you have a system that concentrates risks in the weakest institutions which then gets transferred directly to the Government.

Senator WIRTH. Is another way of putting this to say in effect through the mechanism of insurance that we have developed, what the Government has done is attempted to take a lot of risk out of the marketplace? Is that another way of saying it?

Mr. BRYAN. It worked just fine as long as you had an industry that worked as an oligopoly. But once you introduced competition to the industry, you basically have lost the profitability and the conservative nature of the industry. So when an institution gets in trouble, the easy way out is always is simply take more risk. So that risk is being absorbed by institutions that really don't have the capital to take the risk.

Senator WIRTH. I think that that's absolutely correct and I do believe that, as you say in your statement, this is the fundamental problem. We have been attempting to do that and we've got to address that if we are going to have any opportunity to take on the long-term implications of this whole industry, whether we should have one, two or three different systems or whatever, we've got to address this fundamental issue first and foremost.

Mr. **Bryan**. And I think the shadow committee approach provides one way of trying to narrow risks. I propose others in my statement. But when institutions are playing with the Government's money and they become undercapitalized, you've got to take away their ability to take risks. Such that risk takers should be forced in the marketplace.

I think that it's very important that you combine a holding company concept with deposit insurance reform because otherwise the national economy will suffer.

Senator **Wirth**. Let me ask you to jump back to page 3. In the middle of page 3, you talk about there's a further problem as well and you cite the example of empty buildings and some of the troubled markets.

What concerns me is not, going beyond the empty buildings, is all of the other assets that are out there. We're in a situation of attempting to work out the problems that exist, say, in Denver or Houston or wherever it may be.

The Government is ending up owning an enormous amount of real estate, a lot of houses and a lot of property, and so on, in these markets.

And it seems to me that there is in this a thread as to what happens next. What do we as the Government do with all this property?

If we unload all the property, you know, it's already of low value, if we unload then all of the property, the values go down further, causing an even greater problem, it seems to me, with existing financial institutions. And not only the remaining healthy S&L's but other depository institutions as well.

So, what do we do about that?

THE PROBLEM OF GOVERNMENT OWNED REAL ESTATE

Mr. **Bryan**. I think that you need to place the property out to bid on a work-out, rather than a liquidation basis, using incentive clauses to put a private investor in the same seat as the Government basically and you give the private sector a share of the recovery value—maybe it's 10 percent or 15 percent of the share of the recovered value of the asset over time.

And you use the best work-out people in the country, which are—in some cases, real estate developers, in some cases healthy thrifts, in some cases healthy commercial banks, in some cases healthy other financial institutions.

But, you basically have people bid for the right to work out for the most advantageous terms. And you pay them a maintenance fee while you do that.

That's much cheaper than operating the entire institution.

Senator **Wirth**. I'd like to talk to you at some point further about that, if I might, Mr. Bryan, because it seems to me that we face the problem of trying to stabilize the institution, say, in Colorado. It's stabilized on one level but, on the other hand, we've got the potential of all of this load pulling it down further and having a spreading kind of a problem.

And we're going to have to be very, very attentive to that issue.

Mr. **Bryan**. I think that we have real estate weakness developing in many parts of the country, not just in the Southwest or the West, but the Southeast and the Northeast as well are showing some of the same signs as early Texas days. And I think that's very concerning.

Senator **Wirth**. Thank you again, Mr. Bryan.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Wirth.

Senator Bond.

Senator **Bond**. Thank you, Mr. Chairman.

I'd say to Mr. Carron I certainly appreciated your analysis of where all the money went. There are a lot of people asking where the hundreds of billions of dollars went. And I think your analysis was most helpful.

One thing I wanted to pursue with you was your suggestion that we don't need to have thrifts required to participate to any given degree in home mortgage loans.

Would you say, therefore, that we should no longer allow Federal Home Loan Bank advances?

Or should those perhaps be based on function alone going to any institution, whether it's savings and loan or other Federal institutions that makes home loan mortgages?

Mr. **Carron**. I think that's a sound approach. If you wanted to keep this system in operation as a means of providing liquidity for home lending at favorable rates, it should then be available to any institution, regardless of the charter, that was engaged in holding mortgage loans in its portfolio.

And, in fact, membership in the Federal Home Loan Bank system today is not restricted exclusively to savings institutions. There's a very small number of insurance companies, for example, that are members already.

Senator **Bond**. Mr. Bryan, you have criticized the Southwest plan, and Professor Horvitz has also criticized it less directly.

I think many of us really are still puzzling through what went on. In your answer to questions earlier on, you did indicate that there could be some value to the franchise which would be lost in liquidation.

Do you see no franchise value that is maintained in the Southwest plan by the mergers and acquisitions of the troubled thrifts?

Mr. **Bryan**. The average restructured thrift during the third quarter had a negative net worth of 40 percent. So, I think it's pretty evident those institutions have not been able to generate real earnings.

Senator **Bond**. If they had good locations, if they had attracted customers, regardless, even if their management was bad, that does not necessarily mean, does it, that the new institution operating properly could not be profitable, does it?

Mr. **Bryan**. Certainly, if you use the Southwest plan approach, these institutions should be profitable. Given the massive nature of the commitment of funds, they will be profitable.

The issue though is whether or not it's less cost and liquidation. And if you include the tax benefits, our estimation is it adds roughly 25–30 percent to the cost.

In other words, if you roughly had a $35–40 billion liquidation cost for the institutions that you instead restructured and assuming all the Bank Board's assumptions were correct, you would still have to add $10 billion of tax savings to those, which would clearly tip most of these institutions in favor of having them liquidated.

Senator BOND. To what extent does your analysis take account of the contractual rights that the FSLIC and the Home Loan Bank Board has to either recapture increases in the value of the assets or even to take a piece of the action in the thrift itself?

Mr. BRYAN. Given their available information, we have taken that into account. So that we're talking about the same numbers. Our attempt to reverse engineer them.

Senator BOND. Would you explain briefly to us what those recapture rights are and how you evaluate? What value you place on them?

RECAPTURE RIGHTS

Mr. BRYAN. Well, the biggest one is the guarantee, the tax benefits. There's been a 25-percent rule where FSLIC gets it back. But, in the Perlman deal, for example, my understanding is, for an annual $30 million fixed payment, the remainder of the tax benefits went to the Perlman group.

So, actually, each deal is cut differently, making it very hard to respond to your question. We basically assumed a 25-percent rule for doing all the analysis.

Now, on the——

Senator BOND. I was told at one point it was 50 percent. Is that not——

Mr. BRYAN. There are so many deals. I am sure there are some deals which—and I've got to say that it has not been very easy to get the information. And even if you had the information, when you have 18 inches of paper, which the Perlman deal represents, it's very hard to extract much of value from the 18 inches of paper.

So they're——

Senator BOND. That's the same problem we face, and we were hoping that you could give us a little guidance on the answer. That's all.

Mr. BRYAN. I'll say that the complexity of the deals are such I wonder how anyone is going to be able to regulate and police them.

I think you need a separate regulatory agency just to police the $90 billion of liabilities that are in the Southwest plan deals.

Senator BOND. Would you give us your valuation of the right to recapture the value of depressed assets?

And also your valuation of any right that FSLIC and Federal Home Loan Bank Board has to participate in, or should take a share of a profitable institution?

And when you finish that, I would ask Professor Horvitz with his experience if he has any different views on the structure as he understands the Southwest plan.

Mr. BRYAN. We gave very little weight to any ability to gain value from restructuring of the real estate. And the reason we gave very little weight to it is because much of the depressed value is due to capitalized interest, which cannot be recovered from the market ever.

Basically, you can build a new building without incurring that capitalized interest again.

And there is a big benefit to the institution from having that property because if you sell it, you get a significant tax benefit from that process.

In other words, the property is marked back to full back value through the guarantees. But, if you sell the property, FSLIC gives you tax-free cash plus you get a new tax loss on the depressed value.

That tax loss then can be shared with the Government, depending upon how it was negotiated and the particular deal.

Mr. HORVITZ. I think we can make some progress on this in a rather simpler way. For many of the large deals that were done—not all of them, but for many of them, particularly those in Houston in which I have more familiarity—the institutions involved—First Texas, Gibraltar, Home Savings, United Savings—these are institutions with a market presence, a branch structure and substantial local core deposits.

There is substantial franchise value to those institutions. And it is clear to me that an assistance to keep those institutions in business is almost certainly going to be cheaper for FSLIC than liquidation.

So it is appropriate for FSLIC to try to do a deal that recapitalizes these institutions and keeps them in operation.

Now, as to the particular terms of the deal, it's very hard to evaluate. But, the fact is that there was competitive bidding for those. And in the First Texas Gibraltar, my understanding is that there was a very large number of bidders.

That competition of bidders for these assures that FSLIC gets as good a deal as it can, given that it doesn't have the cash that would help it do a more efficient deal.

Senator BOND. Thank you, Mr. Horvitz.

The CHAIRMAN. Thank you, Senator Bond.

Let me just make an observation in terms of sharing information with the committee.

As we were coming down through the end of December and these deals were in the works and we were reading about aspects of them in the newspaper and seeing them on the evening news, and so forth.

As the incoming chairman, I went ahead, Senator Bond, and contacted the Federal Home Loan Bank Board. And I asked for information about some of the high visibility negotiations that were going on. And I asked in writing on behalf of the committee.

And we were informed by the Board that they could not share that information, that they felt they're in a situation where that was proprietary. They were in the midst of negotiations and they gave us a polite generic turn-down.

I felt very unsatisfied by that answer under the circumstances. And so I took a series of steps at that time. But one of those was to ask the General Accounting Office that day to begin a systematic audit of all the deals done in the month of December, to go down through with experts the 18 inches of paperwork on one deal and however much on the others, and so forth, to try to really understand what had happened and be in a position to come back and report to us as to what they found—were they competitive, were they sound, what was the long-term cost, et cetera?

So that work is underway. We will have that information in due course. It's very complicated. It's very time-consuming. But I know of no other way to be able to get those situations out into the full light of day and understand them.

COMPETITIVE BIDDING PROCESS

One other point with respect to the competitive bidding issue. There's a real question as to whether or not we had authentic competitive bidding. And let's just put that issue on the table because now that it's been raised, maybe Dr. Horvitz' view that we did—I've certainly heard from many others who felt that the bidding process in many instances was very helter-skelter.

And, while in the beginning, people were invited to express an interest, as the process went along, a preferred acquirer was identified.

Isn't that correct, Mr. Horvitz, in many cases?

Mr. HORVITZ. I'm not familiar with the details of the procedure. I've heard complaints from——

The CHAIRMAN. Well, let me just say I think it's very important then before asserting that it was done competitively that an effort be made to be very familiar with what the arrangements were.

What I have picked up, and it's anecdotal in terms of wanting to track it all down, is that the number of people who wanted to be in the bidding process all the way to the end were invited out of the process quite early, as the designated acquirer was very often established.

And then the terms kept changing, kept changing very radically, I gather, in a number of cases. And, in effect, what you had was not a competitive bidding process all the way down to the end, but one that ended very early. And very often what you had at the end was a package quite different than the one you had at the beginning.

And it's very important if that's so that you know that, especially because you're in the system. And you are part of the system.

But I just cite that because that appears to be the case. Now, you know, I want you to be free to comment on that.

Mr. HORVITZ. Well, I've been involved in this process at the FDIC, where I worked for about 10 years. And the FDIC, as I assumed the Federal Home Loan Bank Board as a regulator for the industry, would want to have the right to exclude certain bidders that they would conclude were incapable or inappropriate to be in the bidding.

So it would be reasonable to keep out some bidders. I have heard complaints from some bidders that the process was unfair, and I think it's appropriate for the committee to look at that closely.

But the reluctance of the Bank Board to make public the details of these deals certainly makes one suspicious. And I wish they were more open about revealing the details of the done deals.

The **Chairman**. Well, I'm going to yield to Senator Dodd. You had a comment you wanted to make?

Mr. **Bryan**. I just think that you really ought to look at the bidding situation. I really think that it matters a great deal which lawyers you had on your side, which consultants you had on your side, how close they were to the Bank Board.

I mean, I think that there should be a full exploration. I do not think that the kind of procedures the FDIC used, for example, in its sell-off of First Republic, were used.

You went down to one bidder very quickly in my understanding.

The **Chairman**. You're talking now about the Federal Home Loan Bank Board?

Mr. **Bryan**. The Federal Home Loan Bank Board, as opposed to the FDIC, where they kept three bidders open until the last day.

The **Chairman**. We'll come back to that.

Senator Dodd.

Senator **Dodd**. I might recommend this, too. Senator Bumpers of Arkansas——

Senator **Kerry**. Mr. Chairman, could I just interrupt?

I ask my colleagues' indulgence for a minute, because I have to go to another committee for a second.

I just wanted to second the thought of Senator Wirth with respect to the comparison; I think it would be very helpful for us. And I've read the study and was frankly dumb-struck by the cost differential between the two approaches.

And I'd just like to second that, if I may, before I leave.

The **Chairman**. Thank you, Senator Dodd.

Senator **Kerry**. Thank you, Senator.

Senator **Dodd**. Yes, I would certainly recommend you talk to Senator Bumpers. He regaled me for ½ an hour yesterday with just that kind of fact situation you described, where in Arkansas solvent, healthy S&L's were interested in a couple of thrifts that were in weakened shape and went through a nightmare of a bidding process.

Let me, if I can, come back. I made a suggestion at the outset of my opening statement about some immediate action, sort of a dual-track approach, in terms of trying to at least reduce some of the growing costs before we come up with a solution.

In your testimony, Mr. Bryan, on page 5, you mentioned that keeping the Southwest plan institutions open will cost the Government 30–40 percent more in net present value terms than outright liquidation, when one includes tax consequences. And you provide the chart and so forth that bears that out on page 6.

As I mentioned in my opening remarks, it's going to take some time to craft a solution here, and I am interested in the idea of some immediate infusion of dollars—to expedite the liquidation process.

In fact, Mr. Horvitz, in your American Banker piece on January 27, as you list the finding fault here, you mentioned Danny Wall and you say that:

> Deals can be criticized . . . the ones we're just talking about . . . but it's hard to find better solutions given FSLIC's lack of cash.

CASH FOR LIQUIDATION PURPOSES

What I'd like to know from all three of you is whether or not you think it makes sense for us to pursue this idea of trying to come up with an immediate infusion for just liquidation purposes. And how would each of you suggest that those dollars be targeted to get the most bang for the buck, if you will, to minimize growing cost?

I should ask the first question first: whether or not you think actually you'd save money by doing this? Save either the Federal Treasury or whoever else is asked to belly-up to pay this bill?

Mr. BRYAN. Many have sympathy with the Bank Board because they have no cash. I think last year, Mr. Wall had plenty of opportunity to ask for cash. Last May, his number was $22.7 billion, which was, quote, "within the resources of the industry."

So I think that you have to examine the issue of how come the estimate was so low and, therefore, the cash was not forthcoming?

The reason I say that without changing the regulatory structures, I'm not sure giving cash by itself, will do anything. I am not sure the Bank Board is committed to any policy of liquidation.

I think the evidence is just the opposite. I think they are——

Senator DODD. I understand that. But your point is, you say in your statement here on page 6, you say:

> We believe that if the Government wants to minimize its costs of resolving this crisis, it should shift to a policy of liquidating the remaining hopelessly insolvent thrifts.

We all realize we've got to create a new structure, but we're going to spend a good many months debating that very question.

Mr. BRYAN. My question is: Who is going to liquidate them? Without dealing with the other issue, the Bank Board is not committed to a liquidation program. In fact, just the opposite.

So, providing the cash, they can use the cash to meet the guarantees they've already committed to and can do more Southwest plan kinds of transactions.

But I'm not sure that FSLIC will start a liquidation policy if all you do is give them money.

Senator DODD. Mr. Horvitz, you're sitting at the other side, and then Mr. Carron.

Since you're in the middle on this issue, I'll allow you to go last.

Mr. HORVITZ. Well, I think there are some candidates for liquidation. I can't really spell them out. I'm sure the Bank Board is better able to do that.

There are some institutions—for example, one deal they did under the Southwest plan involving Sunbelt Savings and several other institutions, they could not find a bidder for. No one wanted it. No one was willing to put capital into that.

That's a pretty good indication that there isn't much franchise value, and that might be a candidate for liquidation.

I was on the board of an MCP case in Lubbock, an institution that had about $800 million of deposits, less than $50 million of which were local, core deposits.

That institutions were providing no local service. That would certainly have been a good candidate for liquidation if FSLIC had the cash.

So I believe they would do some liquidations if they did have the cash. They have done some in California and elsewhere. And I believe they would do that if they had the resources to do it.

Senator DODD. No one's advocating an immediate infusion of dollars if it's just going to add to the cost.

Is it your view that an infusion would substantially reduce the overall problem?

Mr. HORVITZ. There are some institutions where it would be better to liquidate. If we were to liquidate a Sunbelt, say, all those other institutions that are competing with it would have their franchise value enhanced.

And so there would be some savings. But, I would not be suggesting that the majority or even a significant minority of the institutions would be better liquidated than recapitalized.

Senator DODD. Mr. Carron.

Mr. CARRON. Let me just add that if you give the FSLIC that additional tool, the ability to liquidate as an alternative, even if they choose not to liquidate in a particular case, it gives them much better bargaining power because they have that alternative.

Senator DODD. Let me ask you a quick question.

On the issue of the S&L's paying a share of the clean-up cost, there's been a suggestion that if we put further levies on the healthier S&L's, that we'd end up destabilizing the currently healthy thrifts and put tiny thrifts at a competitive disadvantage vis-a-vis other types of banks and financial service providers.

How would you three suggest we go about determining how much the industry can contribute toward the clean-up before destabilizing the industry or making it noncompetitive?

Mr. HORVITZ. I think we've already reached that point, or exceeded that point. I suspect that simply the special assessment that savings and loans are now paying exceeds the ability of them to continue paying that and survive as a viable entity.

Senator DODD. Mr. Carron?

Mr. CARRON. I would agree. I certainly wouldn't raise it above what they are currently paying.

Senator DODD. Mr. Bryan.

Mr. BRYAN. I would agree. And the only thing I would add is any incremental ability for healthy institutions to pay deposits should be used to create a reserve for the future for their problems, not to pay for the cost of this mess.

Senator DODD. Thank you very much. Thank you.

The CHAIRMAN. Thank you, Senator Dodd.

Senator Gramm.

Senator GRAMM. Mr. Chairman, let me make a couple of points that I think are important in lieu of some of your comments and the implication of what some of our witnesses were saying.

First of all, it's my understanding that once a deal is completed by FSLIC, the deal then becomes part of the public record.

The question is the appropriateness of opening up the books when a deal is being negotiated. And I think that's an entirely different thing.

Second, I just have to say—I know we all get these stories about these guys with these great deals that can't get them approved by FSLIC or FDIC. I would guess I get 10 times as many of those as any other Member of the Senate. And some of them, I just cannot understand why the deal didn't go through.

But, on the other hand, in a significant number of cases, this amount of asset they were going to put up turns out to be a great piece of land between Midland and Big Spring. [Laughter.]

So I think we've got to be cautious in terms of what we're saying. I'm not swayed by the criticism of Danny Wall for not asking for enough money. The GAO, which we're holding up as the end authority on this Earth, was talking about $25–26 billion last year.

Finally, let me just ask a question. I've got very little time, so I'd like to get short answers.

If liquidation is the end-all and be-all, I assume there's nobody here that would claim that the FDIC is not perhaps the most efficient Government agency that we have ever seen operate in an area of dealing with losses.

And if you think that's not right, please say so.

And let me just start with you, Dr. Horvitz, and then go to the left.

If liquidation is the solution to the great bulk of financial problems, how come the FDIC rarely ever does it?

Mr. HORVITZ. One reason is the FDIC gets into the act quicker than the FSLIC, and they don't have the very large embedded losses that the FSLIC has in its shock.

LIQUIDATION IS NOT ALWAYS THE SOLUTION

But I agree with you that liquidation should rarely be the solution. But at least it is an option in some cases, and FSLIC should be given the resources to be able to do it when necessary.

Senator GRAMM. Mr. Carron.

Mr. CARRON. I don't have anything to add to that.

Senator GRAMM. Mr. Bryan.

Mr. BRYAN. I absolutely agree that if you take the FDIC's approach, liquidation is not the best answer. I'm talking about hopelessly insolvent institutions. I'm not talking about the vast majority of commercial banks or in fact anywhere near the middle third category of S&L's of the ones that are still solvent.

It's just that you have had so many institutions that have been brain dead for so long that their only value is raising broker deposits and putting those into buildings that have no value.

Senator GRAMM. I'm not sure I disagree with that. The question is:

How big is that as a percentage?

And, again, I think it's very difficult and complex. I think the case you make against the Southwest plan—and believe me, there are many things that I would like to change about the Southwest plan. I'd like more private capital, because every dollar of private money that goes into this hole is a dollar that we don't have to take out of somebody's pocket. The problem is that given the deals that are available, the Lord is not providing people with all this private money that I want to see.

As I look at the deals they've put together, in some of these cases, there clearly were franchises that had value. And there's no doubt special interests within the industry would have been better served had some of the other institutions been shut down and eliminated as competitors. It's just hard for me to believe that the general public interest would have been served.

Mr. **Bryan**. I guess one of my questions is:

Why are there no more commercial banks involved in these deals, who would have the natural best use of franchise value?

Another question I would have is:

How can you even compare liquidation versus keeping open if you don't cap the maximum upside. The Government on these deals is absorbing all of the risks.

If interest rates go up by 2 percent and stay up for the 10-year period, you've doubled the net present value cost.

So the problem is you're comparing a known cost of liquidation to an unknown cost of keeping it open.

Senator **Gramm**. Well, wait a minute now. How can you say, if you've got all this uncertainty, how can you know the cost of liquidation?

The one point you argue with that is totally unconvincing to me is that if you've got uncertainty, liquidation is always better. Liquidation doesn't eliminate uncertainty.

What it does is it converts uncertainty into knowledge at the point that you complete the liquidation. But it doesn't eliminate it, especially not over time. You don't know going in when you shut the institution down how much it's going to cost.

You find out pretty quickly when you start to dispose of assets. And if you warehouse the assets, you don't find out. You simply pay somebody a fee to warehouse them who isn't a bottom-line earner.

Mr. **Bryan**. First of all, most of the costs of liquidation become known immediately. It's on the order of 90 percent or 85 percent. What you do not know is the ultimate, the maintenance cost of keeping it open or, in fact, what kind of incentive clauses you could build in if you had bidders for working out of it.

There's no reason you can't work out the assets intelligently, separating that from the institution. But you certainly save the cost of using brokered deposits in the institution. And you certainly save the operating costs going forward. And you basically cap your upside, particularly for interest rate risk.

The interest rate risk problem is the one that worries me the most because what they have done basically is these assets do not float with rates, but their interest rate costs to pay depositors can go up . . . I mean, we are facing the situation where rates could go up significantly in the next 2 or 3 years.

All of that risk is borne by the Government. And that is a very, very large unknown. And you can't estimate that.

Senator **Gramm**. Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Gramm.

Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman. I'd like to make two comments and one observation before I ask questions.

The first comment is that I would like to join Senator Wirth and Senator Kerry in asking that the report submitted by Mr. Bryan be submitted to the Home Loan Bank Board for its analysis and response.

The **CHAIRMAN**. We will do so.

Senator **GRAHAM**. Second, relative to the request that you have already initiated with the GAO to review the competitive bidding process, there's another dimension of that. And that is a pattern of behavior where after supposedly a competitive bidding process has come to a conclusion and a winner has been designated, then a long period of subsequent negotiation, including bringing in entities not involved in the bidding process, that procedure has had the effect, in my judgment, of causing firms having once gone through it, to have no further interest in participating in the so-called bidding process.

And I would like to have that added as an element to the GAO study.

My observation is that I'm struck by the increasing similarities between this issue and probably the second or third other major priority of this committee. And that is Third World debt. Your comment, Mr. Bryan, about the cash management cost of keeping institutions alive which must bring in new deposits in order to pay the interest on old deposits sounds very similar to what is happening in a number of countries in Latin America.

Your comments about how to deal with the assets of these institutions sounds very similar almost to the debt for equity bidding process, which is being used in Mexico and Brazil.

And I think that some of the same sense of urgency needs to be injected into both of these problems because the longer we continue to allow them to fall down a deeper and deeper hole, the more expensive it's going to be to work through them.

End of comments and observations.

One issue that this committee and the administration dealing with it is going to have to face is:

How long can we defer taking some action in order to assure that that action is sufficiently comprehensive?

We could be here 2 years from now debating the full extent of the prescription for terminal cancer, failing to have applied some intermediate measures that may have kept the patient from getting to that state of ill health.

The question is:

What do you consider to be the essential critical mass of reforms that should accompany any immediate infusion of new resources?

And what are the reforms that might take the form of a second wave after the initial prescription is administered?

REFORMS THAT SHOULD BE TAKEN

Mr. **BRYAN**. I was, in my testimony, I was trying to lay out what I thought was an ambitious but reasonable reform package. I think that the time pressure is very, very real. At some point, you may have to make a judgment to fish or cut bait on the issues.

I would rather press for maximum reform under the urgency of the problem because I do not think you will ever be able to return to it very easily given the history of narrow self-interest and legislative gridlock.

Senator **GRAHAM**. So you're advocating essentially a one-way theory. Do it all and——

Mr. **Bryan**. And do it expeditiously and, I mean, I think a very tough time period should be set for doing it. I think the time pressure will be the only thing that will cause you to get action.

Mr. **Horvitz**. I think we're venturing on thin ice on that issue because I think that is not a financial issue or an economical issue. It deals with whether it is politically feasible if the cash is given to solve the immediate problem, whether it will prove politically feasible for the Congress to agree on a specific reform proposal.

And I don't know that I can speak to the political feasibility of that. Probably, the only person who knows less about political feasibility in Washington is the Secretary of the Treasury. [Laughter.]

Mr. **Carron**. Senator, let me just point out that most of the issues that we've been discussing here today are not new issues. Regrettably, they've been the subject of congressional hearings, outside studies, reports, books, papers, for many years now.

And I would think that simply marshaling a lot of the research and analysis and testimony that's already been given would allow the implementation of the necessary reforms that all of us agree on in a fairly short period of time.

Senator **Graham**. One area of reform that there seems to be some disagreement upon is the issue of the capital structure within the industry.

On page 16, Mr. Bryan, you make the statement that:

> Since capital requirements are already clearly too high for the lost experience of well-run depositories, I believe the answer is to set tighter lending standards.

I thought I heard Mr. Horvitz indicate that he felt some increase in capital requirements was part of the mix of this. I would like your comments on what should be the criteria, the standards for setting capital requirements.

And, second, since, Mr. Horvitz, you suggest that forbearance, either congressionally mandated, influenced, advocated or legislated, has been a part of the problem, what should be the standards by which the regulators should be able to waive or modify or defer those capital requirements?

Mr. **Horvitz**. I don't believe that those issues are matters that have to be resolved by this committee or the Congress. I think it would be a mistake for the Congress to attempt to specify capital requirements.

I think the agencies recognize the need for higher capital requirements. And over the last several years, there have been several substantial increases in the regulations or the proposal.

The Bank Board's latest proposals on capital regulations go a long way in the direction that we have advocated. The real problem would be the difficulty in implementing that given the problems of the industry.

But I think the regulators are aware of the need for increased capital and I think they are moving in that direction.

And I think perhaps more important, the industry recognizes that. Now, we don't have the trade associations arguing against stiffer capital requirements any more. I think there's a general recognition we've got to move in the direction of tougher capital standards.

Mr. **Bryan**. I think the problem with capital standards is uniform standards with differentiated risk. All of our analysis, commercial banks in particular, shows that the best half of the industry is overcapitalized. They have far more capital than their charge-offs. I mean, they have 20/30, 40/1 kinds of coverage ratios at the upper end; while the bottom 20 percent clearly don't have enough capital.

And the same is true in the savings and loan industry to a lesser degree. And I think that we need to put capital pressure on the weakest portions of the industry. But at the same time the risk-taking of institutions without that capital needs to be limited.

The **Chairman**. Thank you, Senator Graham.

Senator Heinz.

Senator **Heinz**. Thank you, Mr. Chairman.

One question that amazingly enough we haven't touched on is the issue of whether there should be any incentive for the people who put deposits in institutions to be careful about it.

Now, as long as it was Senator Gramm's mamma putting anything between $1 up to $100,000 of her life savings into a deposit, we didn't care. We didn't think that Senator Gramm's mamma, or anybody's mamma, needed to be an expert on that particular institution. That's why we have FDIC and FSLIC insurance. That seems utterly appropriate.

But, a tremendous industry arose when money market funds needed to place money in S&L's and banks where they could get a safe return. Deposit brokerage has become an important subindustry of that.

Somewhere along the line in this process, the major depositors, this semi-indefinable group of people with large sums of money, have lost, and have been disconnected from the need to be responsible for what they're doing with their, or for that matter, somebody else's money.

If you really want to take the broad view of what I've just described, is there something we should do about a different kind of intermediation? Do we need to inject some kind of risk-bearing in the brokered money process I described a moment ago?

If so, what? And if not, why not?

Mr. **Horvitz**. I think we don't from the depositor. There is a trade-off between market discipline and stability. Deposit insurance pushes us in the direction of stability at the expense of giving up market discipline.

I think that's a good trade-off. I think it is better to have the stability in the system that full deposit insurance provides——

Senator **Heinz**. Does anybody disagree with Mr. Horvitz?

Mr. Bryan?

Mr. **Bryan**. I . . . I spent a lot of that year I told you about trying to explore alternatives. And I reluctantly came to the conclusion that deposit insurance is part of the social contract. And that you cannot get any real discipline to the market given the accounting practices of the industry now. It's blind-pool risk. There is no way that even some of the people in the institutions understand the risk, let alone outsiders. In such a situtation you cannot get effective market discipline.

And I think that the potential for panic is very extreme. You cannot close these institutions down like that. And if you can't do it like instantaneously, you cannot bag the nonmom and pops. Even if you can bag them once, they will pull money from dozens of other institutions in the very next moment.

Senator HEINZ. Now I think somebody proposed at some point, and I don't know who it was—and maybe there was more than one author of this proposal—that deposit insurance of $100,000 should be limited to only a single depositor.

What would happen if, in fact, that idea was adopted although it might be complex and difficult to enforce?

Mr. HORVITZ. My view has been—I've seen sketches of such a proposal. It seems more complex than it's worth. I would rather seek market discipline.

Senator HEINZ. I understand that. But assume that in this day and age of computers, the complexity is solved with a microchip—although it may not be. What would be the effect on the industry, on home owners, or whatever else is relevant here, of such a limitation?

Mr. BRYAN. I don't know how it would work. I mean, that's what I was trying to say. You've got to instantly close down the institution to bag people, because the smartest people with the most money, as soon as they see closure coming, they're going to leave. And then you create a run.

So, I mean, I don't know how you could actually capture them with their liabilities still in the institution.

Senator HEINZ. Do you mean you don't know how——

Mr. BRYAN. Mechanically.

Senator HEINZ [continuing]. Anyone would ever figure out whether an institution was risky?

Mr. BRYAN. No, I think you can figure out how an institution is risky. What I don't see is how you can capture the uninsured depositors into the system. Every time that has been tried, they have mobilized their money to move it.

If they move, then you wind up with a panic situation.

Senator HEINZ. I hear you.

You know, one of the things that I'm taking away from this hearing is that we're under a lot of pressure to do something. That is to come up with maybe not all the money, but some of the money, but also not to deal with reforms now, and to leave that to somebody else later.

RISKS OF PROVIDING MONEY WITHOUT REGULATORY REFORM

I might add that this scenario doesn't have a lot of appeal to this Senator. But I think we've heard various members and even some of you suggest, that we do a few things but that we don't need to do the whole ball of wax at one time.

What if we don't address the entire problem at the same time. In terms of what money we have to come up with, it's probably somewhere between $50–100 billion present value, as I understand it.

If we don't address the regulatory aspect when we provide the money so that we can be fairly sure this never happens again, what risks do we run?

Mr. Bryan?

Mr. **Bryan**. I think you run significant risk. I really am worried about the deposit insurance system. And I think that without the reform, we can be assured it will recur. I'm much less optimistic than others.

I am very bothered how deeply we've got into trouble, in the nearly longest expansion in our Nation's history, and with interest rates falling for a good portion of that period, I just don't know how we can go into the 1990's without addressing the issues.

Senator **Heinz**. My time has expired. If my colleagues would permit one last question that directly relates to that?

Senator **Gramm**. Please do.

Senator **Heinz**. I thank the Senator from Texas for his kindness.

Just to follow-up. Of the 80 or so thrifts that have been resolved in the Southwest plan, I am told that the average capital of the newly acquired thrifts is some 2.1 percent. Everybody I've talked to says, in terms of how a thrift ought to be capitalized, that 2.1 percent is too low. I see, everybody says, yeah, it's too low.

Shouldn't we require that there be reasonable capital requirements for resolutions that happen after we somehow supply this large bushel basket full of money? Why should we believe that other, newly acquiring or acquired thrifts won't continue to benefit from this kind of regulatory forbearance and that, in effect, the new thrifts that have been created are going to be either now or later just like the old thrifts that are in trouble? Isn't the sorry history of forbearance, ours, regulators and everybody else's, that such a policy is a significant part of the reason for this problem?

Does anybody want to take a crack at that?

Mr. **Bryan**. I think you're absolutely right to be concerned.

Senator **Heinz**. OK. Mr. Horvitz.

Mr. **Horvitz**. I'd agree. The only part, if everyone were prepared to accept my regulatory proposal now and enact it, we'd be in good shape. [Laughter.]

The problem is——

Senator **Heinz**. I think there are as many reform proposals as there are members on this committee.

Mr. **Horvitz**. But that's exactly the problem. Everybody has their own pet reform scheme. And my concern is that the time it takes to resolve and agree on a reform proposal, the meter is running all during that time.

And so I would prefer to try to deal with the immediate problem first, and then deal on a more leisurely basis with the regulatory reform situation.

Senator **Heinz**. My time has expired several times over.

The **Chairman**. The problem with that, I think, is that is—you can call it a lot of different things. It's the old bandaid approach, and we've used it before. And you can have a great, big bandaid and you can slap it on, and you can say, "Well, that will sort of stop the bleeding for now. And just as soon as we can, we'll get back and we'll really fix this system."

And we've got enough other things to deal with, a lot of big problems to deal with in addition to this one, that very often, for a variety of reasons, you don't get back to dealing with it.

And we'll have to thrash that out on the committee as to how the committee feels. But it seems to me that our only real lever to bring about the fundamental changes that are needed is to do this as a package.

And so we'll have to see where the weight of opinion comes down on that issue.

In your statement, Mr. Carron, you recommend four regulatory and structural changes. And these are sort of generic but they are nevertheless important.

You say:

> Better coordination of State and Federal regulation, current value accounting—mark-to-market—for regulatory purposes, adjusted capital requirements—which means higher capital, and earlier intervention by the regulators with respect to problem institutions.

Is it safe to assume that your two colleagues at the table would agree at least with that list?

Mr. BRYAN. Mark-to-market accounting is very difficult to apply to loans with no market value. So I would say, for those assets which have a market, that's true. But many of the problem assets have no market.

The CHAIRMAN. I take it that you would agree then, Mr. Horvitz?

Mr. HORVITZ. Yes, I'd agree.

The CHAIRMAN. All right. Let me go to the Southwest plan.

THE SOUTHWEST PLAN

Mr. Bryan, you're very tough on the Southwest plan, and I appreciate the candor of your comments and the others that are here this morning.

In your prepared remarks, you say, and I'm quoting:

> The Southwest plan approach is fundamentally flawed because, one, it is socially unfair since it's got the government in the business of making rich men richer.

Then you list number two:

> It is competitively unfair since it disadvantaged all solvent institutions.
>
> Three, it makes the eventual solution more difficult.

Then you go on to say, quote:

> I believe that to the average American, the single most bothersome characteristic of these transactions is their social unfairness. It is almost as if the Government were playing Robin Hood in reverse.

You'll recognize that language from your statement submitted to the committee.

That's a very tough commentary on the plan. And I'd like you, if you would, in somewhat greater detail give us your specific criticisms with the plan.

Mr. BRYAN. Well, the first, which I've already commented on, is that I believe it cost the Government more money. I think that once you don't have fair competitive bidding and, basically, you operate a process so that some people wind up with very attractive deals, the question is:

How did they do it?

I mean, how'd they get the deal? I mean, why not you? Why not me? What is the discipline in the system?

Basically, to benefit from these deals, you have to have a lot of money. You have to have a lot of taxable income. So that's a subset of the population, so that's one concern. A social concern.

Second, I'm concerned about the institutions that are struggling along paying their taxes. You know, trying to raise deposits and keep in business. They're treading water. And these other guys are out there bidding for deposits and are not going to pay taxes.

I think every investment bank in the country is going to flock to these guys trying to find ways to generating taxable income for them so that they can use their tax shields. I mean, mergers and so forth.

And third is you have now created a new class of investors, so you have yet another special interest. And these are very powerful, well-connected people who are going to want to influence the process. And these are contracts. These are real players now, and they have $90 billion in liabilities and they are in the system. They are now new players in the game. And we had a lot of players to start with, and now we've got a new set.

And I also am concerned from trying to track the industry is I can't tell you where the losses went now for all these restructured institutions. They're now being absorbed in the FSLIC and FSLIC statements come out a different date for itself than it does for the industry.

I mean, so the industry looked like it was getting better in the third quarter but that's because you took a lot of institutions that were losing money off the charts. And it looks like to us, in fact, that the fundamentals continue to deteriorate.

Now, the accounting for who owned the deterioration changed and it's less in the industry and more in FSLIC, but those fundamental problems are still deteriorating.

The CHAIRMAN. Now, are there any other factors? I mean, I'm sure you've mentioned the biggest ones. Is there anything else that's inherently troubling to you about the Southwest plan that has caused you to reach this bottom line judgment?

Mr. BRYAN. I think that those are the principal ones. I think that the overall concern is that we are giving an appearance of dealing with the problem when we aren't dealing with the fundamental structural issues I talked about earlier.

And to the extent that that takes some of the heat off for doing the right thing, I think that is a final point.

The CHAIRMAN. Mr. Carron, do you—I'd like you to react to that. Do you agree or disagree?

Mr. CARRON. Senator, I just haven't looked at the numbers. I haven't really followed the specific deals, so I don't have an opinion.

The CHAIRMAN. All right. To the extent you can, would you take a look so you can give us a comment for the record on that issue, to the extent that you can get up to speed on it?

Mr. Horvitz?

Mr. HORVITZ. I disagree. I think the problem is not that these deals are too sweet for the acquirers. Part of the problem may be that the deals are not sweet enough. That is, because what the acquirers are getting are assets about which they have some doubt—that is, they're getting a note and promises from FSLIC, which is insolvent, and which their accountants are going to have trouble in appraising and valuing.

Because of the question about those assets, the bidders are unwilling to put up sizable amounts of their own capital at risk. That's why some of the large firms—that's why many banks that are well-capitalized are unwilling to put their capital at risk in doing one of these deals.

What happens to someone who is at risk if the Congress should disavow responsibility for FSLIC notes?

They have a loss. And they're going to try to limit their exposure by limiting the amount of capital they put up. If FSLIC had the resources to do solid deals, to really fill the net worth hole, we might see investors willing to put up more capital and perhaps better capitalized acquirers coming into the picture.

I am unhappy with the weak capitalization of these resulting institution. Two percent capital is inadequate. But it's the best that can be done with the resources that FSLIC has.

The CHAIRMAN. I think it's fair to say that, in the past as well, there was a real credibility question as to how well FSLIC could do the job if they had the money.

Now, FSLIC keeps changing. You've got new players. They get more experience. They finally added more examiners. There are a whole lot of things that are different today than were true 3, 4, or 5 years ago.

But I think it's fair to say, too, that there were people around, whether you agree with them or not, that had no more confidence in FSLIC in days past competently managing its way out of the problem than the problem itself.

But that goes in part to your own list of where you've assigned, you know, rough shares, percentage of blame. And you've got a list here that includes about 20 players and everybody gets a piece.

I'll come back.

Senator Gramm.

Senator GRAMM. Mr. Chairman, let me first say to Mr. Bryan that there's a lot of what you say that I agree with. I think Dr. Horvitz is correct that probably the best thing to do would be to put up the money and solve the problem later. But without the pressure of needing the money, the problem would not be solved.

He's right, you're talking about political risks. They exist. But, let me tell you, I find your statement about people making a profit to be an extraordinary statement. I'll make a statement you may view as extraordinary, but I have no doubt about its validity:

If this problem cannot be solved at a profit to somebody, it's not going to be solved. If we cannot, if we're going to take a position that we want people to come in and take terrible risks but yet we don't want them to make a profit by taking the risk, no one will take the risk.

One of the things that worries me and, again, I have been as unhappy with the Southwest plan as anybody, but if we're all going to stand off behind a nice fence and lob rocks over at the Federal Home Loan Bank Board, which is the only institution that's out there where the bullets are, then pretty soon we're going to induce them to sit down.

And the problem's going to get a lot worse. Now, your view seems to be that actually we ought to be just liquidating all of these institutions, and that that's the best way to do it.

If I really believed that that would save money, I'd be willing to do it. But I don't find anything, as I look back at the monetary history of our Nation and other nations, that convinces me that that's right.

Now, having given my little sermon, Mr. Carron, you made a statement that I thought was pretty interesting. You said that the liquidation loss in the 1980–83 period was probably about $90 billion. That's when we had the high, short-term rates, all these mortgage loans.

If your number is right and if Dr. Horvitz' number is close to being right, what you really are saying—and those are two big ifs, but just assume that they are—what you're really saying is that the problem we're addressing today is primarily a problem that was produced at the turn of the decade and that we're only now, 8 years later, coming to grips with it. The real problem here was the rise in short-term interest rates catching a lot of institutions that had these long-term mortgages based on a different kind of financial reality. What we're really doing is seeing that wash through the system.

Now, am I generalizing too much on what you said?

Mr. Carron. Let me just embellish it very slightly. After 1982, as you recall, interest rates did come down. A part of that value was restored, a good part of it. And then after that point, a lot of the additional problems began.

So I think we can attribute a good chunk of the problem that we're working out today to that problem, but not the full amount that my $90 billion estimate of the time might suggest.

Senator Gramm. So you would say that some of that came back. What percentage would you say really goes back to, in essence, our failure at that point to address the problem?

Our response was in essence, to convert savings and loans into banks and give them vast new powers, which, as it turned out, the regulatory agency was not up to dealing with.

Mr. Carron. And the other thing that was done was to allow functionally insolvent institutions to continue in operation and to assume various risks with both new powers and previously existing powers.

I think it's very hard to quantify the amount. I would say that the majority of the costs that we're facing today is the result of actions subsequent to the initial rise in interest rates.

Senator Gramm. But you wouldn't disagree with me that some of it was due to the changes that were made to deal with the original problem? You wouldn't disagree that to some degree it was due to the vast expansion of powers, with a sleepy little regulatory agency that had been regulating home loans in a period of inflation where only an idiot could make a bad one?

Mr. Carron. I basically agree with that comment, yes.

Senator Gramm. Yes, Mr. Bryan.

Mr. Bryan. I would like to say I wholeheartedly agree with you that anyone who takes risks should be able to get a profit.

NO RISK IN PARTICIPATING IN THE SOUTHWEST PLAN

In fact, my criticism of the Southwest plan, however, is that they are not taking any risk. They get their money back from tax breaks and are not absorbing any of the ongoing risk of the institution.

That, in fact, is my problem with them. If they——

Senator GRAMM. Well, if that's true then, why aren't there more people bidding?

Mr. BRYAN. I think that is a very good question that should be explored by the committee. I am very confused because my analysis of the deals indicates, and everyone I talk to, that it's an investment banker's dream. You have no due diligence. The returns are guaranteed. And even your risk of the deals being contested, the legal fees, are absorbed by FSLIC. I find that very strange.

Senator GRAMM. Well, let me tell you, everywhere I am—I'm speaking in Chicago, I'm walking through an airport in St. Louis, I talk to people about it: If you've got any money, invest it in the savings and loan industry in Texas.

Nobody ever lost money by investing in the long-term future of our State. I'm out hawking these things to anybody that wants to listen. For some miraculous reason—maybe it's that greed died or something—[laughter]—but for some miraculous reason, I don't see people dragging big bags of money into these things.

And that's why as I see it, the problem is not enough competition. And it tells me when people aren't willing to put up money, that something's wrong with the deals from the point of view of the investor.

Mr. BRYAN. I would suggest that you should try to seek out those people that tried to get deals and didn't get them and look for competent players. I would think you will find that it was very hard for some people to get into the deal stream in a timely manner, partly because of the sheer number of deals being resolved under the pressure.

But, I've got to tell you I honestly believe it helped to be well-connected with ex-Bank Board employees.

The CHAIRMAN. Well, let's go right into that. I mean, that's an important point to make and, you know, you've been around this problem for a long time.

What gives you that impression?

Mr. BRYAN. My impression is that many of the people that are most—that I have talked to—have indicated that one of the key factors for success was getting the right lawyers and the right consultants, and I think the right tax advisers.

I think some of these issues were raised on the front page of the Wall Street Journal today.

The CHAIRMAN. So your sense is from studying this industry at close range over a long period of time, your contacts with a lot of players, that some people were able to get into the process and others that might have wanted to found it difficult or impossible to get into the bidding process?

Mr. BRYAN. Again, I have only heard stories. I have not personally worked with anyone whose tried to do it. I have no consulting relationship with anyone whose tried to do it. It's hearsay from people who I have talked to about the deals.

I think that is exactly the kind of thing this committee should explore. I do know that everyone who has looked at the deals is puzzled that the price is not better, given the expected net present value to the investor.

The CHAIRMAN. Well, just to try to throw a little light on it, because I think these are important questions and they are relevant questions, and that is that there was something of a gold rush at the end.

My impression, Senator Gramm, is that as we came down through the month of December and as the word essentially got out more widely as to what these deals looked like, and that the value of the tax credits which could be applied against other income in the future and could shelter income, that that became a very attractive package to people who are very sophisticated in terms of financial arrangements.

And so you saw some new players coming in. You saw one well-known Texas family, the Bass family got involved out in California. But then you had the Perlman case in Texas and many others. And I think there was something—I don't know how you would best characterize, but there was a real burst of interest at the end where very sophisticated players suddenly saw that this could be a bonanza.

But I think it's just as fair to say that a lot of less sophisticated players either didn't—weren't aware of it, or they didn't know how to get into the maze. If there were two tracks, the ordinary track and the inside favored track, they didn't know how to get to the inside favored track. We don't know that there was or wasn't such an inside track.

But your anecdotal information would suggest that a lot of people think there is. You cite this article on the front page of the Wall Street Journal today, and I think we'll make that a part of the record.

[The following information was subsequently submitted for the record:]

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Revolving Door

S&L Mess Isn't All Bad, At Least for Lawyers Who Were Regulators

Vartanian, Who Eased Rules For Thrifts, Bills Millions On Takeovers of Sick Ones

A Bonanza for Fried Frank

By JILL ABRAMSON
Staff Reporter of THE WALL STREET JOURNAL

WASHINGTON – The savings-and-loan industry will long remember 1988 as a year of disaster. But it was Thomas Vartanian's best year ever.

Six years ago, Mr. Vartanian was general counsel at the Federal Home Loan Bank Board, helping write laws and rules that freed thrift institutions from decades of regulatory constraints. Thanks partly to the reckless way some S&Ls were soon using that freedom, the U.S. now faces a bailout bill that could hit $100 billion, and one might expect Mr. Vartanian to be squirming these days.

Instead, he is prospering amid the crisis. As a partner at the law firm of Fried, Frank, Harris, Shriver & Jacobson, he generated a staggering $12 million in billings from his work in 55 thrift mergers and acquisitions—many of them involving institutions that crashed and burned in the new deregulated climate.

Wall Street Role

The thrift crisis plays naturally to investment banks' skills in raising money for recapitalizing sick thrifts, and the battle among firms for position is getting brutal. Meanwhile, the Treasury's rescue plan has sparked controversy, but the proposal or something like it is needed. Stories on pages C1 and B1.

Thomas Vartanian

The nation's savings-and-loan bust has been a boom for S&L lawyers here, most of whom, like Mr. Vartanian, used to regulate the institutions. While no one blames regulators for the entire S&L calamity, many critics charge that the bureaucrats were, at the least, asleep at the switch when the industry's problems were developing. They find it galling that some of those same people are today among the big winners from the industry's predicament.

"It's easy to see how the public would see this as a particularly obscene example of people coming back to benefit from their actions in government," says Edward Furash, a banking analyst here.

"Everyone says they feel sorry for the people at the Bank Board," adds Rep. Jim Leach of Iowa, a Republican member of the House Banking Committee. "My impression is that they'll all go out and earn a million dollars. The revolving door at the Bank Board makes the problems at the Pentagon look like peanuts."

Not Our Fault

Mr. Vartanian, a short, bearded man who favors expensive three-piece suits, suspenders and Italian leather slip-ons, strenuously denies that deregulation was a cause of the industry's travails. "Deregulation did not cause the problem," he contends. "Failure to deregulate in the 1970s caused the problem."

And he sees no incongruity between his former activities and his current ones. "People don't come out of a regulatory agency in Washington and become a plumber," he says.

Indeed they don't. Mr. Vartanian's deputy when he was a thrift regulator, Patrick Doyle, now has a thriving S&L law practice at Arnold & Porter here. The man who succeeded Mr. Vartanian at the Home Loan Bank Board, Norman Raiden, does similar work as a partner at McKenna, Conner & Cuneo. The thrift group at the law firm of Jones, Day, Reavis & Pogue includes no fewer than seven former regulators at the Bank Board.

The thrift bar's high-paying clients include on occasion even the government itself. For 1988 alone, the Bank Board and the Federal Savings & Loan Insurance Corp., though they have 200 in-house attorneys, are paying $110 million to outside law firms for work arising from liquidations, management takeovers, mergers and acquisitions. Three law firms billed over $6 million each for such work.

A List of Clients

At age 39, Mr. Vartanian is to the savings-and-loan bar what Donald Trump is to real estate: a powerful deal-maker with a flair for self-promotion. In a profession where client relationships are traditionally kept confidential, he happily hands out a brochure listing 78 clients and 134 transactions for which he has arranged financings, mergers, acquisitions or reorganizations.

Since he joined Fried Frank, Mr. Vartanian estimates, the firm has been asked to represent the acquirer, the target or the underwriter in fully 75% of all thrift acquisitions valued at more than $50 million. "He's been an extraordinary success," says Arthur Fleischer, the firm's top mergers-and-acquisitions partner. Harvey Pitt, a partner who helped lure Mr. Vartanian to Fried Frank and now co-manages its 110-lawyer Washington office with him, jokes that "I should have insisted on a finder's fee."

In December, Mr. Vartanian and his team of 25 lawyers had their meters running for 13 groups seeking to acquire insolvent thrifts in the end-of-the-year fire sale conducted by the Bank Board. In the week between Christmas and New Year's, three major thrift-industry executives—none aware of the others' presence—were nervously camped out in his law firm's conference rooms, waiting to hear whether their bids had been accepted.

Mr. Vartanian's high-powered practice offers a stark contrast with his legal beginnings. In 1972, while working as an underwriter for Aetna Life & Casualty Co., he enrolled in evening classes at Brooklyn Law School. After earning his degree but being rebuffed by private firms, he landed a staff attorney's job with the federal comptroller of the currency. A 1980 assignment, involving a bank merger in Utah, turned out to be a lucky break.

The expert witness for Mr. Vartanian's side was Richard Pratt, then a professor of finance at the University of Utah. Mr. Pratt was impressed by Mr. Vartanian's intensity—"he wouldn't even take time off to come to our house for a Sunday dinner"—and when Ronald Reagan named the professor to head the Bank Board a year later, he tapped Mr. Vartanian to be his general counsel.

"I didn't know what an S&L was" at the time, Mr. Vartanian says. Nonetheless, with deregulation a Reagan administration priority, he soon was writing legal opinions that broadly affected the industry. One, for instance, permitted thrift institutions to enter the securities-brokerage business. He also wrote key provisions of the 1982 Garn-St Germain Act deregulating the industry, giving thrifts far broader lending powers—and, critics charge, opening the door to the carnage to come.

"Vartanian was for giving the thrifts powers without limit and no real supervision," charges Richard Still, a former staff director of the House Banking and Financial Institutions subcommittee. "Now we're all paying the price."

Though Mr. Vartanian was at the Bank

Board for only a little more than two years, he was the most visible general counsel in its history. Following the passage of deregulation legislation, he hit the road, giving razzle-dazzle speeches to an array of thrift-industry groups and potential investors. Some of his colleagues and listeners felt he was also doing a little selling of himself.

"He was into self-aggrandizement," asserts Ernest Leff, a Los Angeles thrift attorney who heard several of Mr. Vartanian's presentations. At the Bank Board, some colleagues nicknamed Mr. Vartanian "Doggie in the Window."

Edwin Gray, a former Reagan press spokesman who succeeded Mr. Pratt as Home Loan Bank Board chairman in May 1983, says he was "quite concerned" about Mr. Vartanian's appearances before industry groups. "Mr. Vartanian seemed to me to be seeking clients for after his departure," Mr. Gray says.

Mr. Vartanian, though, vehemently denies soliciting future clients while he was in the government. With his speeches, he says, he was merely "hawking the thrift charter" at Mr. Pratt's urging in an effort to attract new capital to the troubled industry. "Every minute of every hour I tried to make the best impression I could," he says. "It would have been naive not to."

After Mr. Pratt left the chairmanship to take a job at Merrill Lynch, Mr. Vartanian says, it quickly became clear that he couldn't work with the new Bank Board chief, Mr. Gray. Looking back, Mr. Vartanian says, he left before certain deregulatory safeguards—such as clamping down on state-chartered institutions, increasing capital requirements and bolstering the board's supervisory staff—were put into place. "The mistake was not staying long enough," he says. "The second part of deregulation was strengthening supervision. Unfortunately, we never got to it."

Deregulation's real impact on the thrift industry, Mr. Vartanian believes, was to ignite an explosion of mergers and acquisitions. "An S&L charter became the most liberal charter of any financial institution," he says. Of course, the new investors flooding into the business all needed lawyers to negotiate their deals and get them approved by the Bank Board. Mr. Vartanian's knowledge and contacts—he claims he left the Bank Board conversant "with the financials of every S&L in the country" and "knowing every thrift executive"—made him a hot commodity. Before deciding on Fried Frank, he got offers from 25 other law firms.

Within a week of his arrival at the firm, Mr. Vartanian had three clients signed up. One was City Federal Savings & Loan Association of Bedminster, N.J. Four months earlier, while still at the Bank Board, Mr. Vartanian had written a legal opinion that permitted City Federal to mount a successful $28 million hostile takeover bid for another S&L, Home Federal of Palm Beach, Fla. The sweeping opinion said parties attempting to buy a publicly traded thrift no longer had to get advance approval from the board.

Ronald Tell, City Federal's general counsel, says he was impressed with regulator Vartanian's "innovative" opinion on the acquisition, and it was only logical that the company would want to sign up with him when he went into private practice. "He's a legal dynamo," says Mr. Tell. "You give him a project and you know you'll get results."

Although ethics laws barred Mr. Vartanian from lobbying with anyone at the Bank Board for a year after he left it, he had no problem attracting other clients. He maintained a high profile, writing articles and making speeches. When the year was up, he was able to begin dealing with his old agency, and clients now say he still has a lot of clout there.

"He can pick up the phone and call anybody," says H.M. Osteen, chairman of Bankers First Corp. of Augusta, Ga. At Merrill Lynch, Mr. Pratt says he uses Mr. Vartanian's services at least every 10 days. Goldman Sachs partner John Oros says he may use him even more often than that.

About half of the deals Mr. Vartanian has orchestrated involve healthy thrifts;

the other half are for either sick or insolvent ones and must be negotiated with aid from the Bank Board. In the rush of activity at the end of last year, Mr. Vartanian successfully negotiated with the board the acquisition of two failing thrifts by Pacific First Federal Savings Bank of Seattle, the purchase of Beach Federal S&L by Golden West Financial Corp., and a bid for Tahoe S&L by First Network Savings Bank of Los Angeles.

The assets involved in these takeovers totaled more than $2 billion. The few big deals Mr. Vartanian has missed have usually been off-limits because of conflicts; he couldn't work on the Financial Corp. of America deal, for example, because he had represented a previous bidder, former Treasury Secretary William Simon.

Mr. Vartanian began 1989 just where he left off last year. He is involved now in some 36 thrift deals involving $2.3 billion, including several federally assisted acquisitions that didn't get Bank Board approval in 1988 but are still pending.

Mr. Vartanian is amused at the contrast between his current high-flying life style and his more modest origins. He grew up in a middle-class Armenian-American family on New York's Long Island, where his father was a postmaster. After high school, he attended a seminary college, intending to enter the priesthood. Though he weighed 200 pounds and stood barely more than 5 feet 6, Mr. Vartanian was an avid basketball player and made the seminary team.

These days, the now-trim lawyer works out twice a day in a gym in the basement of his sprawling estate in suburban McLean, Va., where his neighbor used to be Defense Secretary Caspar Weinberger. And in his office at Fried Frank hangs a giant lithograph by the realist painter Richard Estes, showing a New York City D-train making its way across the Manhattan Bridge. Mr. Vartanian keeps it there to remind him of all the years he spent taking the subway between his day job in Manhattan and the law school in Brooklyn. "It keeps me humble," he jokes.

The **Chairman**. But, the bottom line is that it looks like these were very, very attractive financial deals. And now, in the aftermath, as we dig down through the 18 inches of document detail, in some cases, we find what appears to be a case where some of the new investors will get their entire investment back within 12 months, 18 months, 2 years, and be free and clear.

And then in a sense be in a coupon-clipping arrangement with the Government with the Government holding most of the risk, if not all of the risk, out through the next decade.

Is that generally a fair summary of what we're now seeing, Mr. Bryan?

Mr. **Bryan**. That is my understanding. I think that everyone I've talked to says that is the case as they understand it.

The **Chairman**. Now that's what we've asked the GAO to——

Senator **Gramm**. Mr. Chairman, let's let these other people have a say, too.

The **Chairman**. Well, I'm happy to do that. But let me just make my comment and then you'll have another opportunity here in a minute, but I'm happy to have the others comment on it as well.

That is precisely what I've asked the General Accounting Office to take a look at. We don't have the accounting capacity in depth to really go in and wade through these deals, but we've asked that that be done.

And my thought in mind is that we ought to let the facts speak for themselves, but it ought to be out in the clear light of day. I mean, I've had too many indirect answers, incomplete answers—"We can't give you the information," et cetera, et cetera.

I really want to have this stuff put out into the clear light of day so we can all take a look at it, and make an accurate judgment.

But, if Mr. Horvitz or Mr. Carron, either of you would like to comment on this?

Mr. **Horvitz**. I don't have any feel for that. I have heard comments from people who said they wanted to get into deals and lost out. But I have no basis for concluding whether there was any unfairness or unreasonableness about the decisions made.

I don't——

The **Chairman**. You don't have any basis one way or the other, I take it?

Mr. **Horvitz**. I have some feeling that in some cases, FSLIC personnel have operated insensitively and perhaps arrogantly and haven't always seen—the left hand hasn't always seemed to know what the right hand is doing. And there may have been some screw-ups.

I don't have any feeling that people with a legitimate, sizable offer have been unable to get into the process. And I just don't think the deals have been as sweet as Mr. Bryan describes in terms of getting their money back the first year. I don't think that's the way the deals look to me.

The **Chairman**. I want to ask Mr. Carron, and then my time will be up, but I want to make a little public appeal right now through this hearing to all within earshot and what have you.

I'd like to invite anybody that tried to get into the bidding stream and found that they couldn't, or couldn't get straight answers or feels like they were given less than a fair shot, to report that to this committee.

I would like anybody who feels they were in that situation to put the facts down in writing and submit them to us so we have some sense of knowing if there is a group of people out there who feel strongly enough about it that they're willing to come forward and so indicate.

And we'll share that, whatever we receive in that respect, with the committee.

Mr. Carron, did you want to make a comment before I yield to Senator Gramm again?

Mr. CARRON. No.

Senator GRAMM. Well, Mr. Chairman, let me just—I guess I'm about through with questions. But I want to make one point to make it clear what I'm saying.

WOULD-BE INVESTORS WILL LET US KNOW WHEN WE'VE TURNED THE CORNER

My view is that we will know when the point has come that we have turned the corner on this problem. We will know it by the visible behavior of would-be investors in the savings and loan industry. When would-be investors in the savings and loan industry start to line up with cash investment and compete against each other for these deals, we will know we have turned the corner.

I have waited eagerly for that day to come. Because I'm from the State with the biggest problem, I can give you plenty of names of people who feel they've gotten a raw deal.

And let me make it clear that on some of these deals from the information I've seen, I've been astounded that they were turned down. Astounded.

On the other hand, in some of the cases, when you do a little probing what is a wonderful deal to the guy that wants to make it is not such a wonderful deal to the Federal Home Loan Bank Board. I guess a lot depends on whether you begin with a conspiratorial thesis as to whether the Federal Home Loan Bank Board is playing favorites or has some ax to grind.

And I think we have an obligation in this committee to try to look at this and try to make a determination.

But, to me, one fact is clear. And that is that the proposals are not yet sweet enough in view of existing conditions—and a lot of it is just uncertainty. If you look at the industry, if you buy into the savings and loan business, you are committing yourself to this unfunded liability out here of 50 to 90 or whatever billion dollars. You're buying a piece of that. People don't know how big that is. They're afraid of it.

And what may look like a good deal at the current assessments would, if for example we raise the assessment this year, make those deals go completely to pieces.

And I think that's really our problem. When we get to the day that these are very sweet deals and people are lining up, when there's Sears and Roebuck and General Motors and all these people rushing into Texas and Oklahoma and Louisiana to buy these savings and loans, that's when the problem is going to be over.

The **Chairman**. Let me just say, Senator Gramm, that any of those individuals that have come to you complaining that they had a great deal to offer and they sort of were stiff-armed, I wish you'd indicate to them that we would love to hear their stories. And we'll pay attention to them because there may be something to it, there may not.

But the point is that we need to have that kind of commentary and observation and see what we can make of it.

So, you know, I would invite them through you to be in touch with us.

I agree with your notion here that in the end the market test is the one that counts. If we can't attract capital on a reasonable basis into this industry, then that leads to, I think, some other observations that maybe the industry as it's now structured is too large, that there may be too many savings and loan institutions.

And this isn't a brief to say do away with the industry, but it may be that we're beyond an economic size in terms of being able to attract capital on a competitive footing with all other capital seeking opportunities in our society.

So it may well be that there are limits to how much you can take and create sort of artificial incentives internally to attract capital that otherwise is going to stay away.

Now, part of that may be due to the uncertainties of this premium to FSLIC in the future. But I think also part of it is the whole question of whether or not you may have an overexpansion in a sense and roughly comparable kinds of financial service entities.

And it may well be that that's part of the problem here. And if it is, you know, maybe no amount of internal rearrangement is going to fundamentally address that issue.

And if that's the case, I don't want us to kid ourselves. I don't want us to get out into an exercise where we try to do something that fundamentally is uneconomic with respect to market reality.

But I think these are fair questions to raise and I want to raise them on the front end. What I don't want to do is to hook this problem up to the Federal Treasury so money starts flowing into it and then, with a notion that if there's a fundamental problem, we'll take a look at that later on down the line.

I think that would be a real error for us to make. And there may be differences of opinion. We've heard some today here, but those kinds of questions, I think, have to be answered. And I don't think it's going to take us until September to answer those.

I mean, I think we've got to answer those up front and put a lot of—there are a lot of smart people working on it. But, you know, we've got to I think squeeze down the judgments into a consensus here and take the steps we need.

But I would invite your comments on that little line of discussion if any of you want to make one at this point.

And then I want to touch on two or three other things.

OVERCAPACITY IN FINANCIAL SERVICES

Mr. **Bryan**. I think fundamental overcapacity is the real issue in financial services. I think, if you look at the European steel industry for a parallel, you'll find out that when the government subsidized the uneconomic behavior, you can wind up with a very, very long correction process.

And I think that that is in fact what we have. And when you have an overcapacity situation and combine it with the ability to take risk, you wind up with any player that starts having economic difficulties will take more risks. And I think that's a real problem.

The CHAIRMAN. Mr. Carron, did you want to add something to that?

Mr. CARRON. I'll just add just a couple of points. You have overlapping branch systems, duplicate back office operations with excess capacity, operations on too small a scale to be viable over the long run.

And I, too, believe that there is a significant amount of overcapacity.

Mr. HORVITZ. That overcapacity is substantial in Texas. The Southwest plan attempts to deal with that by putting together institutions with an overlapping branch structure so that branches can be closed.

And that has been—the Southwest plan has been successful in achieving that. There clearly still remains overcapacity and liquidation of some institutions is appropriate. But, clearly, not closing down the savings and loan business in Texas.

The CHAIRMAN. But it seems to me you said something earlier that contradicts that. And that is that when you really take a look at the capital—now we're going to go back to sort of a rough and tumble market test:

Can outside capital be attracted in sufficient amounts to put investors' money at risk ahead of Government-guaranteed money in these situations.

And the clear sense I got from you before is the amounts of new capital or the absolute percentage rates of capital that we're seeing in these workout plans in the Southwest is very modest. And I take it that it's far below what you think it ought to be.

Mr. HORVITZ. Yes, it clearly is. And the reason for that is the institutions that are being taken over by these acquirers have liabilities that are out there, have deposit obligations to be met.

The assets don't consist of clean assets, they consist of guarantees and notes from FSLIC that have some doubt. And because the assets don't match the liabilities, at least in terms of their certainty, the individual outside private investors are not willing to put up the amount of capital that they would if they were getting a clean shot.

The CHAIRMAN. Yes. Now, does that lead you then to say that if we take and clean out the risk of bad decisions in the past and we insulate the new owners from that—we take that burden on to the FSLIC fund—are you then prepared to say that the new acquirers are going to have to come in here and, say, provide 6 percent capital or 8 percent capital? If they're not interested, then, you know, then the value of that franchise, et cetera, falls below the market test and it's better to shut it down?

Mr. HORVITZ. I think that's exactly the criterion that should be used. If they've got a clean start, they should be willing to meet the existing capital requirement of, say, 6 percent. If they can't meet that, then that's an indication that liquidation would be better than doing a deal.

The **Chairman**. Insofar as I know, not a single one comes close to that.

Mr. **Horvitz**. Not a single one represents a clean shot.

The **Chairman**. Well, I think we have to take a closer look at that. It looks to me as if it doesn't represent a clean shot. It looks as if the risk, the real risk of the bad loans in the portfolio, has been dumped off on the Government.

Are you suggesting that's not the case?

Mr. **Horvitz**. No, that has been the case, but I think there has——

The **Chairman**. Well, so they've taken care of that risk and yet they're still not putting in the capital.

Mr. **Horvitz**. The risk that remains is how good that guarantee is. If that were a guarantee of the Government, the problem would disappear.

So, at this point, it's a guarantee of FSLIC.

The **Chairman**. So you would be prepared to say then that in any future deal, if it's obvious that the guarantees into the future are in fact bona fide commitments of the Government, which I think most people think they are—they're certainly not selling like junk bonds. They don't have that kind of a premium attached to them over the rates. Some premium, but it's certainly not anything that's a very wide premium.

But, you know, it seems to me then you are prepared to argue then that they ought to come in at a 6-percent capital level, or an 8-percent capital level, whatever it's pegged at, and if they don't do it, then you allow those institutions to basically close down. And you liquidate the deposits.

Is that right?

Mr. **Horvitz**. Yes.

The **Chairman**. Would the rest of you agree with that?

Mr. **Bryan**. If you exclude the tax benefits so they would have to put in real capital, I would absolutely agree with that.

The **Chairman**. Where should the capital standard be, do you think?

Mr. **Bryan**. I think that is a real issue for the Fed and the BIS and others; that is a little bit of a question like how many angels can dance on the head of a pin?

Because without talking about the actual risk the institutions are bearing, it's very hard to get a single capital number.

The **Chairman**. But is it probably at least 6 percent?

Mr. **Bryan**. I think, given—it's certainly in that range.

The **Chairman**. At the minimum?

Mr. **Bryan**. I don't know the actual number. It really depends.

The **Chairman**. Mr. Carron, did you want to express an opinion on that?

Mr. **Carron**. In the matter of capital, it really does depend on the type of business the institution is doing. If it's making loans to individuals, mortgage loans, loans to companies, then it may well be in the 6–8 percent range.

If, however, it's operating effectively as a mutual fund, let's say, where its assets and liabilities are matched in terms of credit quality, in terms of maturity, interest rates and so forth, it can operate very profitably and very safely on a much lower level of capital.

Mr. **Bryan**. And if it's making 100 percent of value construction loans with no lease up in advance, with no personal guarantees, you have to put up equity money?

All equity money. That's not 6 percent capital money.

STATES CAN EXPAND ON FEDERAL OPERATING POWERS

The **Chairman**. Let me ask you this. We've had this anomaly where we've got these federally granted operating powers that we give to federally chartered savings and loans. And then we have this pattern in the 50 States, each State being free to expand on those operating authorities and to broaden them out—and you represent a State, Dr. Horvitz, where the Texas authorities are much broader than the nationally granted authorities.

The same is true in California and some other States.

Why should we continue to allow that? Why shouldn't we line these up? And if the Federal deposit insurance for the National Government is going to underlie these activities, why shouldn't we mandate the width of the playing field and not allow the States to go on beyond that to things that, in turn, can come back on the Federal deposit guarantees?

Mr. **Horvitz**. I would generally agree with that. We've had a tradition of deferring a great deal to States' determination of their financial structure. But, if it's the Federal Government that's taking the risk in the deposit insurance system, it seems to me it's certainly appropriate for the Federal rules to prevail in terms of the riskiness of assets.

The **Chairman**. Do you agree with that?

Mr. **Carron**. Yes, I agree with that.

Let me just give you what the argument is on the other side.

The **Chairman**. I don't want to hear the argument. We'll let the people that want to take the other side make that argument. The fact is you agree with that proposition.

Mr. Bryan?

Mr. **Bryan**. I would agree with the statement that if you charter and insure separately, the safety and soundness issue is the role for the National Insurance Fund, and that the regulation should be national rules for safety and soundness.

The **Chairman**. Now, if you fellows access the capacity of the Federal Home Loan Bank Board today and the regional banks in terms of their whole regulatory capacity today, the number of examiners, how qualified they are, the number of problems there are to monitor, and so forth, is the regulatory structure that's in place today adequate to really keep track of the industry?

Or do we still have a significant shortfall in the capacity of our regulatory structure to really go out and monitor and police the system?

Mr. **Horvitz**. It seems to me the numbers are up to where they should be. The examiners and supervisors of the Home Loan Bank System, many have been very recently hired. There certainly is a need for additional training and experience. And that will improve over time. There is no quick solution to that.

But I think we're clearly on the right track.

The **Chairman**. Well, I know, but that's, you know, that's, if I may say so respectfully, a weak answer because it implies that we had a problem before, that we weren't up to speed, we didn't have enough talent.

And the implication is that helped contribute to the problem. Your own assignment of responsibility says as much.

But it leaves aside the question as to whether we're really where we need to be today?

And if we're not, do we need to really apply additional resources quickly to the problem and the training and the additional slots, if needed, and higher salary levels if that's what it takes to get people with talent?

Do we have a problem in that area or not?

Mr. **Horvitz**. I have the feeling and I have no real knowledge of it, but I have the feeling that all those steps that you suggest are being taken. And I don't think any more resources would speed that up any.

The **Chairman**. All right. That's a straight answer.

Mr. Carron?

Mr. **Carron**. I would agree with that. And I would say that it's not necessary in my view to change the structure of the regulatory system to merge agencies or create new agencies or anything like that to get the kind of results that we want in terms of ensuring safety and soundness.

The **Chairman**. Mr. Bryan?

Mr. **Bryan**. I guess I disagree. The reason I disagree is not that I don't think there are enough examiners out there now. I think there's been great progress made.

I think that they're asking to do something that's impossible. My whole testimony indicates that I think it's a systemic problem that cannot be addressed by just throwing labor at it. I think labor is important.

I really do think that we need to move to a single deposit insured entity so that we basically have one set of rules and we can create a true insurance fund that works. And without that, I'm really troubled.

The **Chairman**. Now, and you've made a strong case for the systemic side of the argument in that, you know, you can have a lot of regulators now and it may be that you passed the critical point in such a way that that doesn't solve your problem.

You just have more people monitoring the problem, so to speak.

A SINGLE INSURANCE AGENCY

With respect—now you've made the point about the single insurance agency. At a minimum then, that would also indicate that you feel that FSLIC ought to be separated from the Federal Home Loan Bank Board, that there ought to be a clear break of those two, one from the other.

Is that right?

Mr. **Bryan**. I really do. I think that you need to have someone with a clear perspective, which is to save the Government from exposure and loss.

I think that's very hard to do when you combine the charter and the insurance function.

The CHAIRMAN. Mr. Carron, do you agree with that?

Mr. CARRON. I guess my answer is no. You obviously need a strong insurance agency that has the ability to go in and close down institutions. But let's look at the case where we have institutions chartered by the States and regulated by the FSLIC.

There you do have a clear division between the chartering and the insurance and that system worked less well than the ones where the Federal institutions were chartered and insured by the same agency.

The CHAIRMAN. Well, with all due respect, I think that's a weak argument. I mean, I think you're talking about things that are really fundamentally different there in terms of indicating that.

I think you'd almost have to take the argument of saying that maybe we should go ahead and combine the FDIC, which is now separate, with the bank chartering and regulating agencies over in the commercial banking field.

Would you be prepared to argue for that?

Mr. CARRON. Well, the view that I expressed in answer to your earlier question is I don't think that the organization of the agencies is that important as long as the deposit insurer has the tools necessary to do its job.

The CHAIRMAN. Dr. Horvitz, what's your thought?

Mr. HORVITZ. I agree with Mr. Carron.

The CHAIRMAN. It doesn't make any difference whether we separate them or leave them together?

Mr. HORVITZ. No. I don't think that's the cause or source of the problem. The Comptroller of the Currency is the chartering authority and it has been a strong and effective regulator. I don't think the organizational structure is really the issue.

The CHAIRMAN. That's interesting. I think, you know, the body of opinion that's building—you two obviously don't share it, but I think most of the comment that we're receiving generally is of the view that there does need to be a division there. And that it seems to have worked better for the FDIC having had it than not having it.

But your view to the contrary is duly noted.

HOUSING AND THE S&L INDUSTRY

How about housing? How important is the savings and loan industry in the future to be a free-standing, specialized financial service industry that's predominantly aimed at housing?

Is that something that's still important or not?

Mr. BRYAN. Housing is still a very important priority. I do not see, given the structural changes Mr. Carron talked about in the market, that you need to have a separately regulated industry anymore; the secondary mortgage is very efficient.

The CHAIRMAN. Mr. Carron?

Mr. CARRON. Well, I don't have anything to add to what I said earlier, unless you have a specific question.

The CHAIRMAN. No. But I want to put it in this sequence where, you know, it isn't just helter-skelter through the record. I want to have it in one spot where we've got three opinions side by side.

Mr. CARRON. I would just reiterate the point that we're not talking about doing away with savings and loan institutions. We're talking about doing away with a regulation that dates back more than half a century that requires them to specialize very narrowly on one single product, when the world and the entire financial system has changed radically since then.

The CHAIRMAN. But is that the same as saying you do or don't think they ought to maintain housing, residential mortgage lending origination and activity as the central focus or a central focus?

Mr. CARRON. I do not believe that thrifts should be required by regulation to specialize in mortgage investments, which is what the rule is today.

The CHAIRMAN. So you would favor then a change in what has been the historic definition of the stated purpose of the industry?

Mr. CARRON. Yes. Yes, I would.

Mr. HORVITZ. I think the only rationale for a separate thrift industry has to be a tie to housing. As to whether they are needed, whether a separate thrift industry is needed to efficiently promote housing, I don't know the answer to that. I think that is a tough question that should not be tried to be resolved in the course of the dealing with an emergency situation.

The CHAIRMAN. Well, but, you know, you, if I have it correctly, you serve on the Home Loan Bank Board in the Southwest region. Is that not right?

Mr. HORVITZ. Yes.

The CHAIRMAN. Well, you must have some opinion on the importance of the savings and loan industry to housing.

Mr. HORVITZ. To some extent, the problems we've had have been with those institutions that have moved away from the traditional support of housing and gotten into other kinds of activities.

I think it is important. We simply don't know at this point whether reliance on the mortgage banking, investment banking, Wall Street link is going to be sufficient to provide the kind of housing finance that we want.

I think that still is an undecided question.

The CHAIRMAN. Is the Board discussing that? Is your regional Board discussing that? And is that not a center-piece issue? Or perhaps it isn't.

Mr. HORVITZ. I don't think that's within the scope of the responsibilities of the individual Federal Home Loan Banks. I think that really is a question for the Congress to resolve.

The CHAIRMAN. Well, it's for us to resolve, but it would seem to me that you folks are, you know, closer. You're regional banks. You have an understanding of what the savings and loans are doing in your area.

I think at a minimum we have a right to expect that the regional boards would have a sense as to whether the housing function, which is the principal, long-term justification for the specialized industry, is still relevant or not.

Mr. **Horvitz**. You're right. And I think the savings and loan industry makes a substantial contribution to housing finance and to the availability of housing in the United States.

And maybe these other alternatives, the secondary market, investment banking, may be able to replace that efficiently. But we don't have the convincing evidence of that at this point. And that's why I would prefer to preserve at this point the separate savings and loan industry.

The **Chairman**. Now let me ask you a related question. And that is that if we're going to go beyond housing and, in fact, the industry today has gone well beyond housing and varies from State to State because of the State-granted authorities, I'd like to hear from each of you just as best you can what you think the kinds of things are that savings and loans ought to have as the operational authorities beyond housing.

In other words, what would fall into the bundle of activities and what clearly in your mind ought to fall outside of the bundle of activities.

Mr. Bryan, what would be your thought?

Mr. **Bryan**. I gave my answer earlier. I think that S&L's should have the same charter as commercial banks, that the expansion of charter powers, particularly in the construction and development lending, has clearly been unwise and has caused the problems.

The issue is: Is there any economic benefit from such expanded charters?

And I think the answer is probably no except for the well-run institutions, who I think would prosper just as well with a commerical S&L charter.

The **Chairman**. So you're in effect saying it's time to move to line up banks and savings and loans, let's move to a unitary definition of a financial deposit taking institution and get rid of the differentiations.

Is that true?

Mr. **Bryan**. Yes, absolutely. I think it's interesting that commercial banks now have more real estate assets than commercial loans, which indicates there's a convergence underway.

The **Chairman**. Well, but you also expressed some concern about that.

Mr. **Bryan**. I didn't say it was a good thing. I am just saying that I cannot see the real estate mandate separating the industries.

The **Chairman**. Well, but just let me just push you one step further. And that is I guess I'm really interested in your opinion as to what ought to wisely go into the bundle of financial services in addition to the——

Mr. **Bryan**. My proposal is that this is a very difficult issue, that you basically should set up a credit standards board made up of private parties, the best lenders in both the thrift and the commercial banks and S&L's. And have them draw up a proposal, an ongoing proposal, which is going to be reviewed by the OCC and the relevant insurance agency; if it's FDIC, it will be FDIC. Otherwise, it would be FSLIC.

I mean, I really think that you need to get the best practitioners into the act in drawing up intelligent rules. They will be actually harder on the weaker players than anyone else because they'll be protecting their own insurance fund.

The CHAIRMAN. Mr. Carron, what do you put into the activities that ought to be done by a savings and loan and what are the ones that you think ought to be kept outside that definition?

Mr. CARRON. I think that savings and loans, savings banks, thrifts generally, should have the same set of powers as commercial banks in terms of what they are legally permitted to do.

I think that what individual institutions will choose to do may in fact differentiate them from commercial banks for a fairly long time to come. I think they will stick fairly close to mortgage lending, consumer loans, to their market base, auto loans, credit cards, and so forth.

In terms of what they should not be permitted to do, I think that Mr. Bryan's suggestion about how you arrive at that list is probably appropriate.

The CHAIRMAN. And of course if you've got tougher capital standards, honest accounting, you've got investors' money at risk first before you ever eat through that to get to the Government guarantees and the tax holder's liability, presumably you get people who are going to be pretty realistic and pretty careful because they don't want to squander their own money first.

Is that a fair——

Mr. CARRON. That's exactly right.

The CHAIRMAN. Dr. Horvitz, what would you put in and leave out?

Mr. HORVITZ. I think we're on pretty much the right track with the Garn-St Germain approach. I would not be any more restrictive than we are now. I think savings and loans should be able to, at the least, be able to provide a broad range of services to consumers, not just home owners, but to be able to make consumer loans. They have real estate expertise and they ought to be allowed to make some—have some kind of participation in real estate development, construction lending, subject to limits perhaps and clearly subject to a rigorous capital requirement.

The CHAIRMAN. Is there anything they should not be allowed to do in your view?

Mr. HORVITZ. I don't think it makes a great deal of difference what we prevent them from doing. They have certain expertise and with reasonable capital requirements and supervision, they're probably not likely to go off into things that are totally inappropriate.

The CHAIRMAN. Why wouldn't you support Mr. Bryan's proposal that says let's just merge these two and have a unitary deposit-taking institution? Do away with the distinction. They've got the same range of operating activities. One may want to concentrate more on one part of the activities, one in another.

Why wouldn't you support his proposal?

Mr. HORVITZ. I might end up with that. I don't think we know enough at this time as to what the effects would be on the housing area of doing that, of eliminating the separate thrift industry.

The CHAIRMAN. Well, it would be helpful if your board particularly took a look at that because you happen to be on the board of the part of the savings and loan industry that's in the greatest difficulty at the moment. And as a result, you know, it's trial by fire and you're in the middle of the fire.

You know, if you folks don't have a view on the future of the housing component as part of the focus of activities of savings and loans, then, you know, that's one question that isn't being looked at properly in my view.

So I'd ask you to take that back and see if you and your fellow board members talk that over and see if you can't send the committee a view on that.

I'd be interested in knowing what the thinking is.

Mr. HORVITZ. Your comment is well-taken.

The CHAIRMAN. I want to say just one other thing in closing.

I appreciate the time and the effort that you all have taken to prepare the testimony today, to have it in ahead of time so that we all have an opportunity to read it and study it and so forth.

I appreciate your respective points of view. I'm going to want to be able to have us call on you as we get down the track here.

Our process will be to try to take and assemble the best thinking we can marshal in the country, across the committee and outside, to try to decide what is the best set of answers.

This problem mix is of an unprecedented dimension. And so we're going to need the best thinking we can marshal coast to coast in this Nation to be able to decide what does constitute the most balanced and sensible and fair and strong answer for the future.

So I appreciate your testimony today and we'll look forward to talking with you further.

The committee stands in recess.

[Whereupon, at 1:14 p.m., the committee recessed, to reconvene subject to the call of the Chair.]

[Response to written questions follows:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM
PAUL HORVITZ

HEARING OF JANUARY 31, 1989

Q.1. The Bank Board has recently proposed a risk-based capital regulation that would vary minimum required capital levels based on both the credit risk and interest rate risk of a thrift institution's portfolio. Certain assets would require no capital cushion, such as cash or short-term government securities, while other assets would require as much as 18 percent capital, such as direct real estate investments or equity investments. However, even if an institution invested all of its assets in risk-free instruments, it would still be required to maintain a flat 2 percent minimum ratio of capital to total assets. This proposal would be phased-in over several years, would require institutions to increase their capital substantially (or restructure their assets substantially), and is generally regarded as a tough standard. What is your view of the proposal?

1. The proposal by the Bank Board for a risk-based capital regulation is a good one. It is a tough standard, but workable, and demonstrates that the Bank Board recognizes the importance of a rigorous capital standard. I would favor an even higher requirement than the 8% risk-adjusted proposal, but that need not be achieved immediately. In particular, I believe the minimum of 2% capital to total assets is too low. The issuance of this proposal indicates to me that there is no need for legislation on capital requirements, as put forth in the Administration plan. I view as an important part of the Bank Board's capital regulation the proposal for "early intervention" that was put out at the same time. Again, I would favor a higher cutoff point for early intervention than the 1.5% in the Bank Board plan, but that is at least a start.

Q.2. The Southwest Plan transactions have been criticized for resulting in thrifts with too little capital in proportion to total assets. (One figure puts the average at between 2 and 3 percent.) FSLIC's response is based on the risk-based capital proposal described in my first question. Its argument is that most of the assets in a newly-acquired Southwest Plan thrift are a combination of FSLIC notes and FSLIC-guaranteed assets, both of which in effect have short-term interest rates. FSLIC assumes that the government will make good on these commitments, and as a result, they are risk-free assets for the new institution, like cash or U.S. Treasury securities. As such, they require no capital cushion under the Bank Board's new risk-based capital regulatory scheme. The institution must still contribute substantial capital to support the risky assets in its portfolio, and must still meet an overall requirement of two percent capital to total assets even if it is entirely invested in risk-free assets. In addition, any new assets would have to be supported by capital according to the risk-based scheme. According to the Bank Board, virtually all of the new Southwest plan thrifts satisfy the new risk-based capital minimum requirements, with high capital levels in relation to the assets that are actually risky. In short, while the capital-to-total-asset ratio is typically low, the capital-to-risky-asset ratio is typically quite high, and therefore the "moral hazard" to take excessive risks because of low capital levels is simply not present. What is your response?

2. As indicated in the answer to the first question, I would rather see a higher capital ratio even if most assets are riskless. The problem goes to the incentive or moral hazard issue raised in the question. There may be a temptation to take risk as long as the owner's stake is small. The fact that the existing assets are riskless is not relevent to that decision. The owner may be tempted to acquire very risky additional assets if it is only the FSLIC that is at risk and not his funds. More specifically, I do not know how much capital the Agreements negotiated require when the covered assets are replaced by normal risk assets. This is one example of the problems that FSLIC has created for itself by not making the information on completed deals public.

Q.3. Do you believe that the separation of FSLIC from the Bank Board is necessary? Please elaborate on this point. Do you believe that the combination of the chartering agency and the insurance agency creates an inherently risky situation? If not, why not? Do you believe that the separation of the two agencies would have short or long term deleterious consequences? If so, please explain.

3. I do not believe that separation of the FSLIC from the Bank Board is necessary. Neither the Bank Board nor the FSLIC has been well-managed in the past. Neither, for that matter, has the Immigration and Naturalization Service, but no one has suggested moving that to the Treasury Department. The usual procedure is one of trying to improve the poorly-performing agency or replacing its head. There is no inherent conflict in having the chartering agency responsible for deposit insurance. In fact, when I worked for the Office of the Comptroller of the Currency in the mid-1960's, Jim Saxon was criticized for a liberal approach to national bank chartering and powers. He was able to take that position, it was argued, because he had no responsibility for paying the bill if these policies resulted in failures. That has always been the argument for consolidation of the banking agencies. But the thrift industry already has the consolidated regulatory/supervisory structure that appears to be efficient. It is important to distinguish long-run and short-run problems. The supervisory deficiencies of the Bank Board were substantial, but they have been pretty much resolved. The caliber and number of supervisory/examination staff have been greatly improved. I do not believe that the FDIC has any better capability to handle thrift problems from here on out than the FSLIC. So nothing will be gained in the short-run by giving this responsibility to the FDIC. In the long-run, it is certainly appropriate for Congress to consider the structure of financial regulation. Some consolidation may be appropriate, and the role of the Federal Reserve should be re-examined. But that can not be done in the rush of resolving this immediate financing problem for the FSLIC.

Q.4. Occasionally, we have heard criticism of the fact that the supervisory responsibilities of the Bank Board have been shifted to the Federal Home Loan Bank System? Do you believe that this transfer of functions has been beneficial or detrimental? Do you believe a conflict arises due to the fact that the Bank System is member-owned, and thus in effect is policing itself? Isn't it true that the supervision of Federal Reserve member banks is carried out under a similar model? Have they experienced conflict of interest problems?

4. There is no conflict in having supervision of savings and loans carried out by the Federal Home Loan Banks which are owned by the savings and loans. The industry does elect some directors of the Home Loan Banks, but these directors have no role in the supervisory activities of the Banks. I am a Director of the Dallas Home Loan Bank, and I have never even heard any confidential information concerning a member institution. I do hear a fair amount of such information, but I usually hear it from reporters. The point is correct that this structure is not any different from that of the Federal Reserve System.

The reason the supervisory responsibilities were shifted to the Home Loan Banks was simply as a means of evading governmental salary and manpower ceilings. That does raise serious public policy concerns--not so much about supervision of the thrift industry as to the problems of the rest of the federal government. I think it is disgraceful that the Congress is unable to act responsibly on a pay raise for itself. It is even worse that that unwillingness to increase Congressional pay is then imposed on the rest of the governmental salary structure. If that were resolved, we could move supervision back to the Bank Board.

Q.5. You have endorsed market value accounting as an important regulatory tool. Should this apply to all financial institutions? What are the arguments against using market value accounting?

5. I believe that all financial institutions should be required to report **estimates** of the market value of their assets and liabilities on a regular **basis**. It is not necessary to extend this to a full market value accounting system, with all books maintained on that basis. The arguments against simply go to the difficulty of implementation. All proponents of market value reporting recognize that such information is difficult to obtain for some assets. I think that the key reason many in the banking and thrift industry oppose market value reporting is that they are carrying assets at more than their market value.

Q.6. If Congress put full faith and credit behind FSLIC notes, wouldn't they become the equivalent of cash? If so, wouldn't that solve FSLIC's cash problem?

6. With a full faith and credit guarantee FSLIC notes would become almost the equivalent of cash, but that would not solve all of the FSLIC's problems. Some insolvent institutions should be liquidated, and notes can not be used for that (in fact, the suggestion that the FSLIC might do payoffs using notes would be very likely to generate runs). Nevertheless, it would certainly save money (and would have saved money in December) if the Congress had acted on this earlier.

Q.7. What recommendations would you make for curbing the use and abuse of state-chartered thrift powers? Should all state powers be cut back to federal powers? Or should the regulators be made to adopt tougher standards that still retain some flexibility to approve innovative state changes that don't pose a threat to the insurance fund?

7. The federal deposit insurance system should not be exposed to loss at the whim of state legislatures. However, we have seen some useful innovations arise at the state level, and I would not like to see that potential eliminated (at least not when Congress is so unwilling to act on controversial issues). Without action by the states we would not have interest on checking accounts and we would not have seen the progress on interstate banking that has been achieved in recent years. The suggestion that the federal regulators have some flexibility to approve state changes has appeal to me.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM ANDREW S. CARRON

HEARING OF JANUARY 31, 1989

Q.1. The Bank Board has recently proposed a risk-based capital regulation that would vary minimum required capital levels based on both the credit risk and interest rate risk of a thrift institution's portfolio. Certain assets would require no capital cushion, such as cash or short-term government securities, while other assets would require as much as 18 percent capital, such as direct real estate investments or equity investments. However, even if an institution invested all of its assets in risk-free instruments, it would still be required to maintain a flat 2 percent minimum ratio of capital to total assets. This proposal would be phased-in over several years, would require institutions to increase their capital substantially (or restructure their assets substantially), and is generally regarded as a tough standard. What is your view of the proposal?

Q.1. The FHLBB proposal is an important step toward establishing adequate capital levels at insured depositories. The specific levels proposed for given assets should be adjusted according to the criteria given here.

Capital serves two purposes in a depository institution. It provides an incentive to the owners to prudently evaluate the risks and returns of an investment, and it provides a buffer against loss for the deposit insurer.

Even comparatively small amounts of capital can create sufficient incentives for careful operation, as long as "real" capital is in place. That is to say, there must be a positive market value net worth position to avoid the "moral hazard" problem. The minimum ratio of capital to total assets can be seen as providing the necessary incentives.

The risk-based guidelines should be seen as serving the role of buffer. Assets whose performance makes the portfolio more volatile may require higher levels of capital, and vice versa. In this context, volatility means the extent to which the value of an asset can change during the intervals between asset valuations. For example, financial assets should probably have lower required capital levels than real assets, because the former can be more readily and more frequently evaluated. Also, assets whose volatility reduces overall portfolio variability should be accorded much lower capital requirements.

Q.2. The Southwest Plan transactions have been criticized for resulting in thrifts with too little capital in proportion to total assets. (One figure puts the average at between 2 and 3 percent.) FSLIC's response is based on the risk-based capital proposal described in my first question. Its argument is that most of the assets in a newly-acquired Southwest Plan thrift are a combination of FSLIC notes and FSLIC-guaranteed assets, both of which in effect have short-term interest rates. FSLIC assumes that the government will make good on these commitments, and as a result, they are risk-free assets for the new institution, like cash or U.S. Treasury securities. As such, they require no capital cushion under the Bank Board's new risk-based capital regulatory scheme. The institution must still contribute substantial capital to support the risky assets in its portfolio, and must still meet an overall requirement of two percent capital to total assets even if it is entirely invested in risk-free assets. In addition, any new assets would have to be supported by capital according to the risk-based scheme. According to the Bank Board, virtually all of the new Southwest plan thrifts satisfy the new risk-based capital minimum requirements, with high capital levels in relation to the assets that are actually risky. In short, while the capital-to-total-asset ratio is typically low, the capital-to-risky-asset ratio is typically quite high, and therefore the "moral hazard" to take excessive risks because of low capital levels is simply not present. What is your response?

Q.2. The adequacy of capital in the Southwest Plan transactions should be evaluated according to the criteria described above in the answer to question 1. It should also be recalled that, whatever the investors' net investment may be, a successful institution will provide them with higher returns than an S&L that ultimately fails. Even if the institution were acquired at no cost to the investor, the existence of real capital in the institution provides an incentive to maximize the value of the firm, and that argues strongly against taking excessive risks.

Q.3. Do you believe that the separation of FSLIC from the Bank Board is necessary? Please elaborate on this point. Do you believe that the combination of the chartering agency and the insurance agency creates an inherently risky situation? If not, why not? Do you believe that the separation of the two agencies would have short or long term deleterious consequences? If so, please explain.

Q.3. It is largely irrelevant whether the chartering agency and the insuring agency are in the same or different entities. Separate agencies reduces the potential for conflict of interest; combined agencies improves the information flow between regulator and insurer. As long as the insurer has sufficient authority to withhold or withdraw deposit insurance coverage, the requisite discipline would be provided.

Q.4. Occasionally, we have heard criticism of the fact that the supervisory responsibilities of the Bank Board have been shifted to the Federal Home Loan Bank System? Do you believe that this transfer of functions has been beneficial or detrimental? Do you believe a conflict arises due to the fact that the Bank System is member-owned, and thus in effect is policing itself? Isn't it true that the supervision of Federal Reserve member banks is carried out under a similar model? Have they experienced conflict of interest problems?

Q.4. I have no views on the performance of the supervisory function since it was delegated to the regional banks.

Q.5. You have endorsed market value accounting as an important regulatory tool. Should this apply to all financial institutions? What are the arguments *against* using market value accounting?

Q.5. I wish to distinguish between "current value reporting" and "market value accounting." Inasmuch as some assets and liabilities are not traded on markets, I prefer the term "current value" to "market value." More substantively, I think it is desirable for all financial institutions to report on a current value basis to their regulators. The important goal is to give regulators an early warning of impending problems. It may be appropriate, however, to preserve traditional (GAAP) accounting for public disclosure. Many documents (including legal statutes, bond indentures, profit-sharing plans, etc.) are written in terms of accounting results, all of which would have to be renegotiated if market value accounting were adopted. Moreover, the standard of accuracy in current valuation cannot be as great as with book (original cost) valuation; this standard would be adequate for the regulator, who has substantial discretion, but might fall short for purposes of public disclosure.

The arguments against market value accounting are as follows: (1) Many assets cannot be accurately valued on a day-to-day basis. (2) Public disclosure of market value net worth would reduce confidence in the integrity of the banking system. (3) It is inappropriate to value a going concern at its liquidation value. (4) The use of current value reporting strictly for regulatory purposes would still require public disclosure under the Freedom of Information Act.

Q.6. What recommendations would you make for curbing the use and abuse of state-chartered thrift powers? Should all state powers be cut back to federal powers? Or should the regulators be made to adopt tougher standards that still retain some flexibility to approve innovative state changes that don't pose a threat to the insurance fund?

Q.6. States should be permitted to charter and regulate depository institutions, as they do now. However, the federal deposit insurer should be given authority to deny or remove coverage from institutions being operated in a manner that is likely to impose costs on the insurer. The criteria for granting or withholding coverage should be explicit, and should be developed through the normal rule-making process.

Q.7. On page three of your testimony you state that "developments in the secondary market have lowered most mortgage rates below thrifts' costs." If this is the case, do you believe that traditional thrifts will not be economically viable in the future? How do you explain continued reports of profits in thrifts today who are conducting traditional thrift business?

Q.7. In a recent paper, another economist and I concluded that thrifts cannot expect to earn a reasonable rate of return on mortgage portfolio lending. A traditional thrift can nevertheless be profitable if one or both of the following conditions holds: (1) The thrift earns sufficient profits on origination and servicing of mortgages, nonmortgage investments, and low-cost deposit-gathering to offset inadequate returns on mortgage investment. (2) The thrift holds long-term mortgages funded by short-term deposits, and interest rates fortuitously decline. Profits of traditional thrifts over the last few years can be explained by these two items. I have attached a copy of this paper for your information.

PROBLEMS OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION [FSLIC]

PART I OF IV

THURSDAY, FEBRUARY 2, 1989

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Cranston, Sarbanes, Dixon, Sasser, Shelby, Graham, Wirth, Bryan, Garn, Heinz, D'Amato, Gramm, Mack, Kassebaum, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The Chairman. The committee will come to order.

Let me welcome our witnesses at the table.

I want to indicate to the committee and our witnesses that when we have a full quorum present this morning, we will interrupt the proceedings briefly to act on the nominations of two Cabinet officers, Dr. Boskin, as the head of the Council of Economic Advisers, and Jack Kemp to lead the Department of Housing and Urban Development.

Today we have with us the Comptroller General of the United States who is here to report on the work that GAO has done, at our request, on the problems of FSLIC and the savings and loan industry.

Let me say initially that this is our second in a series of hearings on the FSLIC problem. Next week we will hear from Paul Volcker who will come as an expert outside witness. We will hear from the Justice Department which is dealing with the fraud element of the S&L problem. Then on February 2, Treasury Secretary Brady has agreed to present formally the administration's plan for dealing with the problem.

Today, the General Accounting Office will testify. It is the independent, investigative and auditing arm of the Congress. As such, GAO is one of the few parties that can provide us with an independent assessment of the FSLIC problem. The agency's views and recommendations deserve particular attention and I think they should be given special weight.

In their testimony this morning GAO makes several major observations. First, it expresses serious reservations about the way the

Bank Board acted in the rush of deal-making in the month of December last year.

Second, it recommends that FSLIC be made independent of the Federal Home Loan Bank Board. In other words, the insurance function should be separated from and kept apart from the chartering and general regulatory structure of the industry.

Third, GAO suggests that without major changes to the structure and management of the deposit insurance system the Federal Government potentially faces additional large losses in insuring deposits.

In dealing with this problem, GAO recommends that the Congress use an on-budget approach that fully discloses the funding sources and the outlays that will be involved in any financing package that is adopted.

So we look forward to the testimony in each of these areas. I am particularly pleased that we have Mr. Bowsher as a witness today. He and the GAO have been involved in a number of different rescues and workout situations and that experience puts the agency in a particularly good position to be of assistance to the Congress in this matter.

Before we proceed let me again reassure thrift depositors that while our deliberations are underway depositors themselves, within the insurance limits up to $100,000, have no need to worry about the safety and soundness of their savings. Congress has pledged the full faith and credit of the United States behind all insured deposits regardless of the condition of the institution that holds them. Not one saver has yet lost a penny of federally insured deposits yet and none will lose in the future. President Bush has made a similar statement just several days ago.

So with that, let me call on Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

Today we continue the hearings that you began 2 days ago on the problems of the thrift industry. I wasn't able to attend the first hearing but I understand, Mr. Chairman, that you began by emphasizing that the full faith and credit of the U.S. Government stands behind federally insured deposits in both banks and thrifts. I applaud you for making that clear once again and I want to second what you said loudly and clearly. There will continue to be a rash of publicity as we move forward to a legislative solution to the thrift crisis. I wish we could minimize the constant drumbeat of the crisis and the scaring of many of the depositors around the country. So I will repeat what I am about to say many, many times in the coming weeks. Federally insured deposits in this country are safe and secure, no matter what the controversy we see surrounding the thrift crisis. Not one depositor has lost a nickel of his or her federally insured deposits, whether in a bank, in a thrift or a credit union over the last several years. And that won't happen now.

I wish that message would get out as we constantly hear the drumbeat of the crisis—and it is and it does cry out for solution, but federally insured deposits are safe and those depositors do not need to worry about losing any of their money or rush to take their deposits from one institution to another. The President emphasized that himself last week.

Let me turn now to the general subject of these hearings. I understand that Tuesday's hearing produced a range of views about what has happened to create the thrift crisis and what ought to be done about it. Two of the issues discussed I think are especially important. The first is deciding who pays for the mess. I understand that some of my colleagues are in a hurry to dump the entire bill on the taxpayers and I would like to state again that I completely disagree. The taxpayers are the very last people we should look to for payment since they are the least responsible for causing the problem.

What I remember is a thrift industry that 2 years ago claimed that this is only a $5 billion problem, opposed the FSLIC recap in the amount of $15 billion that this committee and the Senate passed in October 1986, and a House of Representatives in 1987 that only thought it was a $5 billion problem and that's all they passed. And so that's a game the industry and the House of Representatives have been playing for some time with an attitude of let's keep our powers and make someone else pay for the mess. Well, I won't support that position.

The second issue is whether we ought to provide some initial funding to FSLIC without regulatory reforms and then pass a second package later that would focus on these reforms. The argument is that FSLIC is losing $1 billion a month and that we can't afford these kind of losses if Congress takes until the end of the year to act. I believe that is not the way we should approach this issue. I agree with the chairman that we should do both at once, as I've seen this body too many times handle an immediate problem and not look at the longer-term problem. I think it's highly important that as we solve the financial problem that we make structural changes and reform in the system at the same time or I'm afraid the reform and the structure changes will never occur. It doesn't always happen, but this committee can move very fast when it wants to and I believe we all want to get this behind us as soon as possible. I certainly support Chairman Riegle in moving as rapidly as we can.

Congressional delay already has caused enough of this problem. There's been congressional delay over the last 2 or 3 years.

I'm also a little bit tired of hearing that the problem is growing at the rate of $1 billion a month and I don't want to try and underestimate the size of the problem. Everybody knows that it is large, but we've been dealing with estimates for a long time that are taken as percentages of what losses occurred before—estimates that are off the top of people's heads. I would expect before this week is over that we will have an accurate estimate as to the size of the problem because each institution across the country is being surveyed and we will finally have an answer that shows us the extent of the problem instead of floating figures from one extreme to another including $1 billion a month.

I would suggest that it is not $1 billion a month. Most of the losses that have been reported in the last year are real estate write-downs that have already occurred and FSLIC is simply recognizing them. They do not grow each month because FSLIC is doing nothing about them. They are already there whether we solve the problem now or later. Don't misunderstand. Sooner is better, but I'd like to keep the problem in proportion, as serious as it is. There are huge operating losses that continue to mount. They are nowhere near $1 billion a month.

FSLIC's actions during the last year, no matter how much they may be criticized or praised, have recognized and reduced these losses. We do need to act quickly to resolve the remaining insolvent thrifts and stop their operating losses, but we do not need to throw around numbers that are very much exaggerated.

So I wish to emphasize, Mr. Chairman, two things in my statement today—the need to move through these hearings and act as rapidly as possible; and just as important, to link the funds necessary to solve this problem to a structural reform package. The two should go together and I will support you in both those efforts.

The CHAIRMAN. Senator Garn, thank you very much for those comments. I appreciate your willingness to work together and move as rapidly as possible to deal with both the structural and the financing sides of the problem.

Let me now yield to Senator Cranston.

OPENING STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. I would just like to make two brief observations. On the issue of how much it's costing each month as time goes on before we work out a solution, I don't think any of us know that figure. The best estimates I've heard range from I think about $½ billion to $1½ billion each month. I would be interested, Mr. Bowsher, in any light you might shed on what the figure is. Whatever it is, it is not inconsequential. The estimates of the total bill have been escalating at the rate of about $5 billion or $10 billion a month for some time now since we heard the earlier much lower estimates.

I think there's some misunderstanding on one other point and that's what some of us feel in terms of the urgency of dealing with the problem. I don't think that we should resolve how to deal with the problem financially now without accompanying that by reforms, but it's apparently going to be about a 3 year problem or more getting money each year to meet the immediate needs and if we can stem the current bleeding or hemorrhaging by providing some funding fairly soon while still recognizing we're going to have to provide a lot more funding before we complete the task and therefore we will still have a lot of leverage, I think we should consider doing that.

It's a very complicated issue that's before us and I just don't know if we're going to be able to resolve it between all the delays we have already encountered, with the administration not ready to give us its advice as early as we had hoped, with many witnesses to be heard, and also complications to be considered within this committee and then on the Senate floor and meanwhile the House will be going through the same process perhaps coming to some different conclusions, and then we will have probably a prolonged and rather difficult conference on the matter with the administration and others having their input at every inch along the way.

So I hope we can resolve the whole thing fast, but if we cannot, I think we should be ready to consider coming up with enough money to stem the hemorrhaging now, recognizing more money will be needed and that that additional money will not come until we've reached a decision on reform.

The CHAIRMAN. Thank you, Senator Cranston.

Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Chairman, I join with you in welcoming Mr. Bowsher and I look forward to hearing his testimony. Since we are once again looking at the broad questions of the size of the problem, funding, regulatory solutions, I will speak to an issue which has much to do with the broad solution.

We've heard frequent criticism of the current state of the thrift industry and the performance of the Bank Board. This is all relevant to our discussions only if we're looking ahead to the solution to this problem. All the review and oversight that's already been done gives us an excellent appreciation of the history of this problem and a painful recognition of the fact that the problem grows with each day and each delay.

However, as many rush to deride the current condition of the industry and the Bank Board's efforts to deal with the problem through the Southwest plan, many of my colleagues on both sides of the aisle have been more judicious, more temperate and more thoughtful in their comments. I would like to commend those attitudes.

I agree with Senator Garn that constant railing about the problem without giving people the idea that their deposits are insured, that they are safe, that they will be protected really exacerbates the problem. Those who add fuel to the fire, that's exactly what they're doing and it's irresponsible. So I join those who prefer to counsel positive and concerned action by the Congress over the criticizing particularly from a rather safe distance and having to offer no concrete or positive solutions to the problem. Many criticize the Bank Board's actions in the assisted mergers of last year. Many compare the cost or the theoretical of such assisted mergers to an estimated cost of liquidation and find much fault with the merger option.

I would like to ask, what do you do with FSLIC that's inadequately capitalized and what would they expect them to do when the Congress has provided a format as it relates to tax consequences that they could and indeed did rely upon; and as the bewitching hour of December 31 appeared obvious to them there were deals and mergers that they could put together that would stop some of the hemorrhaging, that they would not be in the position to go forward with if they were to delay.

And there's one particular area—Senator Bond touched on it the other day—I refer to his mentioning of the scandalous and criminal activities of those people who have truly stolen FSLIC funds by various schemes of fraud and gross mismanagement. They are relatively few thrift operators in comparison to all of them who not only stripped the industry of its insurance fund but have brought terrible damage upon the reputation of the sound businessmen and sound practices that make up the bulk of the thrift industry. I know that we will have to visit that question of fraud in the future hearings and I think you've scheduled one for next week on that and I commend you and look forward to the opportunity to ensure that those of us who have very much concern for this kind of activity that we'll deal with that problem and see that it's resolved.

Mr. Chairman, one other area of activity and I'd like to recommend to you at this time that this hearing be considered an interim report. A full report, including an assessment of the commercial banking and FDIC's exposure to regional problems is analyzed as well. We need to know how the entire deposit insurance system is working. Congress should be developing a plan on parallel with Treasury. I'm not so certain that the FDIC's effectiveness in case resolution has been so well evaluated. I hear them coming in and I don't hear the same questions being asked that we're asking as it relates to FSLIC and I'm not so sanguine about the banking industry that we should leave the FDIC out of these deliberations because I am very much concerned that it's not going to be too much further down the road that we're going to find ourselves maybe in a very similar position as it relates to FDIC and some of the even major institutions that have major problems, not just the small institutions in some geographic parts of the country that have been savaged as a result of the decline in real estate values and energy prices and I would hope that you would consider that, Mr. Chairman, and I would think that the GAO would be well advised to look at some of these mergers that have taken place and what the consequences are and the potential liability in the fullness of time as it relates to FDIC.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator D'Amato.

Senator Shelby.

OPENING STATEMENT OF SENATOR SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Chairman, I am pleased that we are here today to discuss with the Comptroller General of the General Accounting Office recommendations for the thrift crisis resolution. I hope we can find the resolution to this problem.

I've studied the testimony here today and found GAO's recommendations to be similar in some respects to those made by other reputable authorities before this committee. The estimated cost of $85 billion hovers within the range predicted by others. Some have gone a great deal higher. And the GAO agrees that providing financial relief without implementing regulatory reform would be tantamount to sanctioning the disaster. I totally agree with that.

I also agree wholeheartedly that we must not slow the momentum for reform here by providing financial resources before mandating the changes that we have to make. However, Mr. Chairman, we cannot afford to let the mounting costs—that is, the rolling snowball of interest and operating expenses—continue much longer. I believe it's imperative for us not to let proposals for change become political footballs. We have a responsibility to the taxpayer to act expeditiously to clean up this mess as quickly as possible.

I believe Congress also bears some responsibility in the creation of this problem and it would be negligent to delay in correcting it.

Our financing options are limited here because there aren't many sources that we can equitably tap for capital. In fact, I might suggest there are none. Any damages recovered from those convicted of fraud that we keep talking about will probably not be enough to cover the Government's legal expenses. Regardless, Mr. Chairman, of our method of financing the solution which we must make, we will make some constituencies unhappy. If we seek to escape some of the hostility by deliberating slowly and keeping it going and ultimately only increase the cleanup cost, we have done no one a service.

The GAO is one of the more important participants in this discussion. The Treasury's testimony later this month will be even more important. I hope that at that time we can then actively begin to resolve the problem.

Mr. Chairman, you have allocated a lot of time to these hearings and I think it's important, but as Senator Cranston said the other day and I joined him, we need to accelerate a solution to this problem.

The CHAIRMAN. Thank you, Senator Shelby.

Senator Mack.

OPENING STATEMENT OF SENATOR MACK

Senator MACK. Thank you, Mr. Chairman.

I want to welcome the three of you and I look forward to your testimony. This is a problem that has developed a great deal of attention in a relatively short period of time during these last few months and I look forward to your input and your advice.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Bryan.

Senator BRYAN. Thank you very much, Mr. Chairman.

I, too, look forward to the comments and testimony of the witness, particularly in light of an article that appeared this morning in the Washington Post and I'm very anxious to hear from the witness.

The CHAIRMAN. Thank you.

Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, thank you.

I want to say that as I listened to the testimony on Tuesday and as I reviewed the GAO's report, I couldn't help but reflect on an experience that one of my constituents recently had. This was a family that had been away on vacation. They came home to find their house burglarized. Their silverware was gone; their televisions were gone, and their stereos were gone. Of course, so were the burglars. They were understandably angry and upset. When their anger subsided they asked themselves some hard questions. Basically the question they asked was how could this have happened to us? They discovered that there were a lot of reasons.

The door could have had a stronger lock. The windows could have been more secure. The alarm system hadn't worked right. The neighbors didn't think to report a strange looking van parked outside their home. The police, it turned out, had not been patrolling the neighborhood very assiduously. As a result of the incident, the community got together. The community, in fact, started a neighborhood watch program. People in that community put in better locks. There were new security systems. Police patrols were increased.

The good news was that, in addition to shaping up security, these constituents had homeowners' insurance for burglary. The insurance company paid for the stolen items. The police had some leads and suggested that some or maybe all of the stolen items might be found and returned. But as a result of the claim, it was likely that their insurance premiums and those of their neighbors was going to go up.

Now did the insurance and all the new security erase the trauma that my constituents suffered when their house was robbed? Probably not. But the best that could come from this constituent's tragedy was the comfort in knowing that steps were being taken to make sure it was almost impossible for it to ever happen again.

Now, Mr. Chairman, I think that is the lesson for us to learn as we grapple with the S&L crisis. Now I have heard suggestions just 2 days ago and today that we restock the house, we keep the same cheap locks on the door, that we keep the alarm system inoperative, and we leave on vacation for another year or two.

Now as we review the mistakes of the past we've got to make sure we keep our eye on the future. To be sure that no depositor will ever lose a single cent as the result of this. Senator Garn has made it clear and I reiterate his position, that no depositor will lose a single cent.

But I don't think that's enough. We have to search out and find those who robbed our S&L's. We have to recover the stolen goods. We need tough security. We need tough cops and we need them now. If a thrift endangers the safety of others it should be closed down first and asked questions later.

S&L operators will then swiftly learn that the FSLIC is an insurance policy with safeguards, not a license to steal.

Thank you.

The CHAIRMAN. Thank you.

Senator Graham.

OPENING STATEMENT OF SENATOR GRAHAM

Senator GRAHAM. I, too, look forward to the testimony that we are about to receive. It seems to me that we have an obvious duality of issues before this committee. One is the desire to move as expeditiously as possible to provide resources since your testimony and others we have heard indicate the urgency of dealing with those institutions that are already in insolvency; but second, the desire for a longer range look at some of the structural problems of the industry so that we do not repeat the experience that we are currently experiencing.

I would suggest that as a means, Mr. Chairman, of trying to marry those two desires that there are a couple of things that we could do. One is that we could ask our staff to begin to place into legislative language the various reforms that we have already heard and the reforms that we will hear today so that as we are securing theoretical testimony and concepts for solution we can also be focusing on the specific language that we will eventually be called upon to recommend to the full Senate and possibly by having that language available to us in draft form accelerate the time that we can meet our obligations.

Second, I think we ought to be asking the administrative agencies what are they doing now, not about those that are insolvent, but those that have been described as the sliding institutions, those that are moving toward insolvency. And I have seen estimates that they are about the same number, roughly ⅙ of the institutions, as the ⅙ who could be described as insolvent.

For example, in my State, one of the largest S&L's reported this week another quarter—and I think that made something like the 13th or 14th quarter—of very substantial losses, that their net worth had now fallen to less than 2 percent, that they had a cushion of slightly less than $100 million of net worth before they went into an insolvent situation. What should we be expecting the regulatory agencies to be doing about that class of institutions so that the $85 billion number we're going to hear today doesn't double over the next year or two as another 500 institutions go into insolvency.

So, Mr. Chairman, I would support your position, which is that we marry immediate resources to long-term reform, but that we try to accelerate the date of that marriage by this committee, quick movement toward placing reforms into legislation and, second, calling upon the administrators to take steps with the sliding institutions so that they don't exacerbate the problem while we're dealing with the funeral procession for those that have already passed the scene.

The CHAIRMAN. Let me just say in response to your point that I am certainly open to putting legislative language certain options that we might consider if there is the beginning of a consensus as to what some of the items should be.

I have to add that we are very short-handed on this committee. As you know, in our first meeting we talked about the need to add to the professional staff because of the sheer enormity of the workload that we're facing and most particularly the problem that we're talking about here today. Within the limits of the hours of the day and the people available to us and to the extent that there is an emerging consensus on the elements of the solution we will try to get things into legislative language. I am very sensitive to the question of time. I want to move just as quickly as it's humanly possible and still do a good job.

Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator **Gramm**. Thank you, Mr. Chairman.

Mr. Bowsher, I welcome the opportunity to have you back before this committee.

I thought I'd look up your past estimates. In May 1988, you estimated that the hole was about $26 billion to $36 billion deep and in October your estimate was $6[illegible] billion to $69.9 billion out to the tenth of a billion. Now your estimate is $77 billion plus. So forgive me if I don't view GAO as being the oracle from Delphi.

The plain truth is that we don't have a good definition of how big the problem is. I have charted out here all the estimates that have been made, and I think this graph makes two points. No. 1, there are a lot of people doing estimating; and No. 2 most of them don't have the foggiest idea what they're talking about, except that everybody thinks the problem is getting bigger. And so do I, and I think that is the relevant factor.

I think that it's very important that we don't become so preoccupied in trying to figure out how big it is that we don't do anything about it. I think it's vitally important that we move ahead and, quite frankly, I'm encouraged, Mr. Chairman, that we are beginning to see people focus on the problem. I think that's the first step toward a solution.

If we've ever been faced with a problem that is a nonpartisan problem, this is it. I don't see any partisan overtones to this problem. Neither political party is going to benefit the least bit from either solving it or not solving it, though I think both will benefit if we solve it instead of simply allowing the problem to get worse.

I can't pass up the opportunity, though it's not directly relevant to your statement here, Mr. Bowsher, but I just want to express my view that since that cold day when the Supreme Court took the lead out of your pencil on Gramm-Rudman and made you a creature of the Congress—a cruel and inhumane act in my opinion—thank God, we have fixed the Gramm-Rudman law and passed that power on to another soul. But since that day I have seen a movement in what GAO is doing that I don't like. I see a movement away from simply reporting the facts in an impartial way to an increased use of opinion. I saw it heavily during the period of time between the election and the convening of the new Congress. GAO reports, which have historically been viewed as being source documents that simply presented the facts as you saw them, have more and more become instruments of stating a policy that often includes value judgments and personal preferences. I think GAO has been valuable to the Congress. I think your record is a proud record. Quite frankly, I hope that this deviation from that proud history does not turn into a new long-term trend. I simply wanted to use this opportunity to say that.

Mr. Chairman, I thank you.

The **Chairman**. Senator Dixon.

OPENING STATEMENT OF SENATOR DIXON

Senator **Dixon**. Thanks, Mr. Chairman.

I am delighted to have this opportunity to hear from Mr. Bowsher about the thrift crisis and I'd like to make two points, Mr. Bowsher.

First, I think it's vital that if bonding or other borrowing is part of our eventual solution to the FSLIC crisis that the financing be done at the lowest possible cost. Estimates of the size of the crisis range from $85 billion to $100 billion or more, which means that each 1 percent of interest expense could represent as much as $1 billion or more. Stated another way, each 1 percent of interest expense we save will likely save as much as $10 billion over the life of a 20-year bond.

Second, we need to ensure that whatever solution we adopt resolves the entire problem. That means we need to have a solution to (1) go back and refinance the all too expensive transactions FSLIC has already completed; (2) resolve the remaining insolvencies; and (3) restore the FSLIC to a sound condition.

A package that's too small to accomplish all three objectives, in my opinion, would be a mistake. It would not solve the crisis. Instead, it would ensure that we would have to come back to it again and again. We need to solve this problem, in my opinion, in one step. I think that's the view of the chairman as well. Dragging out the resolution of this crisis still further would cause further adverse effects, in my opinion, on financial markets that we simply can't afford.

And I'm delighted to have you here today to hear your opinion about the subject.

The **Chairman**. Thank you, Senator Dixon.

Senator Pressler.

Senator **Pressler**. Mr. Chairman, I have a statement for the record.

The **Chairman**. We will make it a part of the record.

OPENING STATEMENT OF SENATOR LARRY PRESSLER

Senator **Pressler**. Thank you. I commend you, Mr. Chairman, for inviting the Comptroller General to appear before the committee today to discuss problems in the thrift industry and the crisis arising from the insolvency of the Federal Savings and Loan Insurance Corporation.

Mr. Bowsher and his staff in the General Accounting Office have much expertise in matters pertaining to our financial institutions. They have delved into the problems of the thrift industry over a long period of time. The solutions the Comptroller General proposes—discomforting as they are—certainly warrant careful consideration. I look forward to hearing his testimony.

The **Chairman**. Senator Sasser.

OPENING STATEMENT OF SENATOR SASSER

Senator **Sasser**. Thank you, Mr. Chairman.

I am pleased that the committee is continuing its examination today of the savings and loan crisis and I want to welcome Comptroller General Bowsher for whom I have the highest regard, and his colleagues from the General Accounting Office here today.

Mr. Chairman, I want to compliment you for scheduling a very comprehensive set of hearings on this whole situation. There are a number of very serious issues to be considered here and I think the first issue that needs to be considered is where is the money going to come from?

I participated with you, Mr. Chairman, in a meeting yesterday with some high level administration officials and others and we found ourselves in agreement on many, many matters until finally I raised the question, "Well, gentlemen, where is the money going to come from?" Then there was sort of a long, pregnant pause and we didn't get a satisfactory answer on that. But we need to know where the money is going to come from to pay for this debacle and we need to know what changes are going to be made and need to be made so that this absolutely cannot happen ever again.

You really can't answer one question, I don't think, without the other because where the money is going to come from and how we're going to keep it from happening again, in my judgment, are inexorably intertwined and we do need some good answers when we finally get to the answers.

Now that doesn't mean we have to proceed slowly. I, for one, believe that this committee, Mr. Chairman, should consider no other legislation during the pendency of this matter and I think it's fair to say that the savings and loan industry bears the primary responsibility here. There are others that we can point to, but the primary responsibility is with the savings and loan industry in terms of the creation of this crisis and also in terms of finding a solution to this crisis. The S&L's are going to have to bear a very heavy burden I think in coming to a solution.

Last, I think we're going to have to find sources of financing that are fair. We ought not to be charging the savers for it. We shouldn't be charging young families that are struggling to provide a new home for their family to pay for the misdeeds that have occurred in the S&L industry.

I want to at long last credit the new administration for coming forward now and grappling with this very serious issue as one of their first items of business. I am encouraged by that and I think the new administration is learning that there aren't a whole lot of options out there.

I look forward to working with them, Mr. Chairman, and with you and the members of this committee in finding a solution. Thank you.

The **Chairman**. Thank you, Senator Sasser, and thank you for your kind personal comment.

Senator Kassebaum.

Senator **Kassebaum**. Thank you, Mr. Chairman.

I'm just looking forward to hearing Mr. Bowsher's testimony.

The **Chairman**. Thank you.

Senator Wirth.

OPENING STATEMENT OF SENATOR WIRTH

Senator **Wirth**. Thank you very much, Mr. Chairman.

Mr. Bowsher, thank you. I enjoyed reading your testimony before the House Banking Committee last week and appreciate your briefings of some of your staff to our office.

I want to say, Mr. Chairman, I think Senator Graham of Florida is right on the button in talking about taking some of the very good themes that are here and that we heard last week or earlier this week from McKinsey and seeing if we could start to get those to begin to look at what the framework of legislation might be.

I would also just like to add a word, Mr. Chairman, about the GAO. I think that this is one of the remaining institutions that has been careful, nonpolitical, presented the facts, and whether there are people around who have various specious economic theories about balancing the budget or whether debt is a good thing for the country or the fact that our foreign trade deficit is wonderful, I think GAO has been one of the few people around who's been honest about stating that this has been a lot of economic nonsense and I want to thank them very much and tell you that there are many people up here who continue to respect your objectivity and the care with which you've done your job and I think that's reflected in your testimony today.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Wirth.

Senator Sarbanes, we were just about to conclude any opening comments by members. I know you have been at another committee and you may wish to make an initial comment and now would be the time.

Senator SARBANES. Mr. Chairman, I think my best contribution at this point would be to conclude the opening comments and hear from the Comptroller General.

The CHAIRMAN. Let me now ask Mr. Bowsher, if you would, introduce your two colleagues prior to making your statement and then we would be very pleased to hear from you.

STATEMENT OF CHARLES A. BOWSHER, COMPTROLLER GENERAL OF THE UNITED STATES, ACCOMPANIED BY FREDERICK D. WOLF, ASSISTANT COMPTROLLER GENERAL FOR ACCOUNTING AND FINANCIAL MANAGEMENT; AND RICHARD L. FOGEL, ASSISTANT COMPTROLLER GENERAL FOR GENERAL GOVERNMENT PROGRAMS

Mr. BOWSHER. Thank you very much, Mr. Chairman. With me today is Fred Wolf on my left who is Assistant Comptroller General for Accounting and Financial Management at the GAO and who has headed up all our financial audits of the FSLIC fund and much of our other work in this area. On my right is Dick Fogel, another Assistant Comptroller General who has headed up much of our program work in the banking and savings and loan area.

Let me assure you, Mr. Chairman, that we are doing this work in an as objective and independent manner as we always have and I hope that it will be received that way.

First, let me ask that our statement be put in the record and I would just summarize it to save some time here from that.

SIZE OF THE PROBLEM

I'd like to start off with one of the things I think that most people ask about and that is how big do we think the problem is at this point in time.

There's no question that we have been changing our estimates over the last year or so, but we have always been trying to point out that this was a very serious problem. Many times when GAO would put forth a number there were other people who said we were being too gloomy, too pessimistic, and the number was not that big.

Needless to say, as the situation has unfolded, I think everybody has come to realize that this is a very serious and a very costly situation.

Our best number at this point in time is $85 billion and that basically would cover the 350 thrifts that have not been dealt with yet. We see this as the cash flow requirements over and above what would be flowing into FSLIC. It would also cover the 200-some-odd S&L's that have been dealt with so far, and reestablish an insurance reserve that we feel is necessary for the thrifts that are healthy and will continue as an industry here. We don't think you can continue to have an insurance fund that has no funds.

So we think that as part of the reform package you have to look at some amount—we viewed $20 billion—as a future insurance fund.

STRUCTURE CHANGES SHOULD BE INCLUDED

One of the main points I would like to get across today is that we strongly recommend that reforms be put into the package and structural changes be adopted before more of the taxpayers' money is committed. We have pretty much summarized that on page 11 of our statement where we say that we believe that FSLIC should promptly take control of all insolvent institutions and these institutions should be placed in receivership whenever necessary until a decision can be made to liquidate or merge them based on a careful assessment of their asset portfolios and the comparative cost of each resolution option. Of fundamental importance, these institutions must be effectively isolated from the rest of the depository institutions industry to prevent them from competing with healthy institutions and their operations must be limited. Consideration should be given to limiting them to investing in high grade securities, managing the bad assets on their books, and accepting deposits at the prevailing market rates.

Now to accomplish this action, the assistance of State and Federal regulators and insurance officials should be enlisted to quickly help assess the quality of assets in these institutions and make the necessary resolution decisions. Arrangements should be made with the FDIC for asset management liquidation services until FSLIC can develop the requisite capability. FSLIC has been making progress in this area, but we believe with the problems still left to be handled that some kind of a merged administrative capability would make sense and should be considered.

We don't think at this time that FSLIC possesses the infrastructure needed to manage this overall program, but we think they have made progress and we commend them for that.

Now, Mr. Chairman, you also asked me and the GAO if we would look at the deals that were made in 1988 and especially in December. We have done that, but we have only been able to look at it on an overall basis. We are still getting the material.

But I'd like—if I could have a chart up here—to just walk you through a couple of situations. One is a typical December 1988 deal. The deals have all been negotiated somewhat differently. But a typical deal, the best we can summarize it, would be that generally a note is given for negative net worth—that's the difference between assets and liabilities. You also generally get a guaranteed return on the assets. This is generally based on what's known as the Texas cost of funds plus generally a little over 200 basis points. Then you get a guarantee for the book value of the assets. That often is up to 10 years. In some of the assumptions made in the cost-benefit analysis, the period of 7½ years was used for having them resolved. Then you get reimbursed certain expenses, mainly selling expenses when assets are sold and worked out and litigation expenses. Then certain regulation compliances are waived, the main one probably being forbearance for capital requirements. Then there are the tax benefits. The one thing that has been worked out that we feel is very good is generally the Government takes an equity position in the S&L, generally in the form of warrants.

So that's the basic deal that was put forward. Now we have some concerns about these deals which I'd like to just quickly summarize here in the next chart. That is, you still end up with institutions that are relatively thinly capitalized. Although there's some private money that is coming in as capital and it's being held out as a private sector solution, when you look at the tax benefits—which are very complicated and we do not know at this time—you might have more of an IRS contribution than a private capital contribution. I think that should be recognized, that the capital coming in here is not all that much net of tax benefits. That would be our general thinking at this time.

What you also are creating here is a new set of S&L's that have a cost advantage over your healthy S&L's and probably your banks and other institutions in the immediate area. In other words, you are really creating a new system, a system that is pretty much built on Government guarantees. One thing that worries us, and why I think reform should be built in here before we do more of these, is it doesn't seem to have the incentives to manage the assets that I think normally you have in situations like this because much of the assets are guaranteed for a number of years here. So you don't have the incentives that we have seen in past bailout situations for management to get in and to work the situation out. I'll go into a little more analysis of that in just a minute.

CHEAPER NOT TO LIQUIDATE

Now as they have made each of these deals, they have had to do a cost-benefit analysis or cost comparison between whether it would have been cheaper to do a liquidation or cheaper to do the merger—the deal route. They have come to the conclusion each time that it is cheaper not to do the liquidation.

But when you look behind how the cost comparison is done, you have to recognize that they have used the FICO interest rate calculation rather than the Treasury interest rate. It is a cost as the law requires—a cost to FSLIC, not a cost to the overall Government. Also, the tax benefits play to the benefit of the cost to FSLIC. But on a net basis a deal is probably more costly to the taxpayer or to the Government than what it appears. Also, it's all based on a present value analysis. So when we're talking about a $38 billion total cost to FSLIC on a present value basis for actions taken in 1988, our best estimate is that that might translate into $60 billion of cash flow over a number of years.

We also want to point out that these deals are very complex and they are going to require a lot of monitoring. So you're going to have to have a number of lawyers and accountants and tax experts monitoring the deals that have been made.

Now if I could just make a couple overall observations and then I'd like to open it up for questions, Mr. Chairman. Having been involved in some of the bailouts in the past, sometimes when I was in Government positions, sometimes when I was back in the private sector, I can give you some history.

The first one was Penn Central. We did not go through with the Government bailout and so they went into bankruptcy. What happened at that time is you still had to have some kind of financing for the railroad to continue, and so the USRA was set up. We did not get the reforms at the beginning of the program. We just literally set up a financing arrangement and so we poured $6 to $7 billion of the taxpayers' money into that situation and a decade later recognized that we were not making a lot of progress. So finally, the legislation was passed in 1980 to get the reforms. We went out and got a top railroad manager to run the railroad and in a few years we were able to get it back in the private sector. The unfortunate part of that is I think if we had gotten the reforms much earlier we could have saved the taxpayers a lot of money.

Now when we did the Lockheed deal, the New York City deal—and I wish Senator D'Amato was here to confirm what I'm going to say here—and the Chrysler deal, we got the reforms up front. We got the reforms built into the package before the Government guarantees were made, and in all of those cases the American taxpayer did not have to ever put up any money. I think they were very successful programs.

I just worry very, very much as I look at this situation that we have put the money or the commitments out there first and we have not built the reforms into the program. And that's why I'm urging now that the Congress consider doing that before more of the deals are made. I think this is important to do. Although the debate is how much is being lost each month, Senator Cranston, we're not sure whether it's $1 billion a month, something less or something more. We're really not sure. But I think the urgency is very important. In other words, I think it's important for the Congress to move forward. I would hope that once you get the administration package, the Congress could take a hard look at it and come up with a good plan that would have the reforms and the money available to resolve this issue. It is by far the biggest bailout situation that this Government has looked at in recent years. It dwarfs the four bailouts that I spoke about earlier. So that's our main recommendation here today and, Mr. Chairman, we would be more than pleased to answer any questions at this time.

[The complete prepared statement of Mr. Bowsher follows:]

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Resolving the Savings and Loan Crisis

Statement of
Charles A. Bowsher
Comptroller General
of the United States

Before the
Committee on Banking, Housing and Urban Affairs
United States Senate

RESOLVING THE SAVINGS AND LOAN CRISIS

SUMMARY OF STATEMENT BY
CHARLES A. BOWSHER
COMPTROLLER GENERAL OF THE
UNITED STATES

In response to a recent request from the Honorable Donald W. Riegle, Chairman of the Senate Committee on Banking, Housing and Urban Affairs, GAO provided its views on how to resolve problems in the thrift industry.

In Summary: GAO recommended providing sufficient funding to resolve what has become at least an $85 billion problem in FSLIC, the insurance fund that insures thrift industry deposits. However, to be sure that this situation is not repeated, GAO recommended that the system be reformed as a condition for committing federal funds.

Changed Structure and Management of the Deposit Insurance System: Without changes to the structure and management of the deposit insurance system, the federal government faces potentially large losses in insuring deposits. This potential for loss is most evident in FSLIC. To protect the integrity of the deposit insurance system, FSLIC needs to be made independent of the Federal Home Loan Bank Board. Healthy and unhealthy thrifts should be put into separate funds so that tougher deposit insurance rules can fairly and equitably be applied to healthy thrifts right away.

Provide Funding: If reforms are adopted, then a plan should be adopted by the Congress that makes funds available to meet the financing shortfall which we estimate at around $85 billion. This plan should (1) provide for budget authority sufficient to finance case resolutions over the next three years, (2) require a thrift industry capital contribution to create an adequate insurance fund reserve, (3) provide FSLIC with the flexibility to undertake short term liquidity borrowing to meet any deposit outflows that might occur, (4) assure adequate controls over spending to protect the taxpayers' interests, and (5) use an on-budget approach that fully discloses the funding and outlays that are involved.

Changed Approach to Resolving Problem Institutions: FSLIC's approach to resolving cases depends too heavily on assistance agreements that minimize FSLIC's need for cash but require subsidies for up to 10 years. FSLIC needs money to achieve more flexibility in its approach. Using personnel resources from other federal agencies, FSLIC should take control of all insolvent institutions over the next year thereby curtailing the ability of these institutions to adversely affect healthy thrifts. FSLIC should then seek to resolve cases at the lowest cost to the government while minimizing adverse competitive impacts on healthy thrifts.

Mr. Chairman and Members of the Committee:

We are pleased to appear today to discuss problems in the thrift industry. My testimony is based principally on a report we are preparing for the House Banking Committee. I will also discuss work we have begun on your request to examine aspects of transactions entered into by the Federal Home Loan Bank Board (FHLBB) in December 1988.

I hope we are finally reaching a point where a comprehensive approach can be taken to dealing with the issues associated with the insolvency of the Federal Savings and Loan Insurance Corporation (FSLIC). We estimate that to fully pay for insurance losses and to put FSLIC back on a solid financial footing it will cost at least $85 billion more than FSLIC currently anticipates receiving in revenue over the next 10 years. Delay will only increase this cost. Delay will also

-- perpetuate the tendency of weakly capitalized and insolvent institutions to squander our nation's wealth on questionable economic endeavors at no significant risk to their owners,

-- weaken our financial system because healthy depository institutions must match the high rates of interest on deposits paid by weak and insolvent thrifts,

-- weaken the regulatory process by creating pressure for lower regulatory standards across the depository institutions industry, and

-- perpetuate the situation in which the actions FSLIC does take will likely be merger agreements that avoid short run cash needs rather than minimize the federal government's costs in resolving cases.

Without question, federal financing will be needed to resolve the thrift industry situation. However, if we want to be as certain as we can that a FSLIC situation is not repeated, we must be concerned as well with changing the structure of the deposit insurance system. It would be a mistake to commit federal funds without adopting key reforms.

The remaining parts of my testimony discuss structural reforms, funding requirements, and the need for changes in the way problem cases are resolved.

Structural changes

The 1980s have been a turbulent period for our nation's depository institutions. Changes in the financial landscape resulting from market developments and legislated deregulation have drastically altered the way that depository institutions operate. These changes have many positive aspects, but combined with changes in the economy and in a breakdown in the regulatory system they have also resulted in new risks and a rash of thrift failures.

In light of these developments, we need to look critically at how the deposit insurance system functions. Our current system provides many benefits to the public that should be preserved. However, the risks to the government inherent in insuring about $2.5 trillion in bank and thrift deposits can be very great. By far, the most serious insurance problems now are in the thrift industry.

To effectively manage deposit insurance risks it is necessary to (1) have sufficient funds to pay for losses, otherwise the credibility of the insurer taking appropriate action is damaged; (2) ensure that levels of capital in institutions are sufficient to absorb reasonably anticipated losses; and (3) have an effective system of oversight and supervision to quickly identify problems, remedy them if possible, and close institutions at the point of their insolvency.

To accomplish these goals two key issues involving FSLIC must be addressed. First, is the problem of FSLIC's lack of independence. Presently, FSLIC operates under the direction of the Federal Home Loan Bank Board which both promotes and regulates the industry. The industry itself is overseen and supervised by the Federal Home Loan District Banks, which, in turn, are owned by each District Bank's constituent institutions. In our view, the Federal Home Loan Bank System's role as an industry promoter has been accorded more importance than FSLIC's risk management and insurance function.

The second issue is how to best reorganize thrift industry oversight and supervision. This will be exceedingly difficult as long as insolvent and thinly capitalized institutions are allowed to compete with healthy institutions. An equitable way must be found to isolate problem cases so that we can "turn the corner" toward more effective oversight, supervision and enforcement of more rigorous rules for the rest of the industry.

To deal with these two issues, we recommend the following:

-- FSLIC should be made independent of the Federal Home Loan Bank Board, and established with a separate board of directors and adequate supervisory capability over both state and federally chartered thrifts. An independent FSLIC should oversee two separate insurance funds--one fund for healthy thrift institutions ("good companies") and another fund for insolvent or thinly capitalized thrifts that would be severely curtailed in their ability to compete with the rest of the depository institutions industry.

- More flexibility should be given to both FDIC and FSLIC to adjust premiums to reflect actual or reasonably anticipated losses.

- More authority should be given to both FDIC and FSLIC to place stringent controls on improperly operated and undercapitalized institutions.

- Greater consistency between banks and thrifts should be established in matters pertaining to powers and operations that materially affect the deposit insurers' exposure to risk.

- Capital adequacy requirements should be strengthened, and the quality of supervision and oversight must be improved through an increase in the personnel and other resources of the deposit insurance funds.

These and more specific recommendations will be detailed in our final report to be issued later this month to the House Banking Committee. The reforms and funding arrangements we recommend should help accomplish the goal of developing an appropriate regulatory structure for depository institutions. FSLIC's financial problems have to be solved. The deposit insurance agencies need to have greater powers over the terms and conditions for insuring both federal and state chartered

institutions. A higher degree of comparability is needed between banks and thrifts in matters that materially affect deposit insurance risk. After these reforms are enacted, it will be easier to consider what other changes need to be made to the federal regulatory structure.

For example, as part of the reform package, we recommend allowing qualified thrifts to choose between remaining in a reorganized FSLIC or switching to FDIC should help Congress in making future regulatory decisions. Business decisions made by individual healthy thrifts will provide useful information about the value of thrift charters and the need for a separately identified thrift industry.

Funding To Fully Resolve Problems Must Be Provided

Insolvent institutions cannot be effectively resolved unless enough money is available. Unfortunately, deciding precisely how much money will be needed and who should pay will be difficult.

As I indicated at the outset, our best judgement at this time is that it will cost FSLIC at least $85 billion more than it currently anticipates receiving over the next 10 years to deal with the problem. Of this amount, $26 billion represents FSLIC's unfunded cost of paying for actions taken in 1988 and $34 billion represents the future cost of acting on the approximately 350 remaining insolvent cases. In addition, $5 billion represents the cost of resolving cases not presently identified as problems, and $20 billion is needed to establish adequate reserves. However, given the fluid nature of the situation and the fact that we haven't analyzed all of the actions taken in 1988, I want to stress that these numbers are only estimates.

We believe the thrift industry should pay as much of the shortfall as possible. However, the industry is currently paying premium assessments that are more than two times higher than those paid by the banking industry. Many believe that indefinite continuation of the special assessment will weaken healthy thrifts and thereby prove self defeating.

Under the best of circumstances, it is not likely that the thrift industry can contribute much more to the funding shortfall. Although we think the healthy segment of the industry should be charged with recapitalizing the insurance arrangements that apply to them, the bulk of the money will have to be found elsewhere. Judgements as to who can pay how much must be made based on what is perceived to be fair. If contributions are not sought from other segments of the depository institutions industry, then the shortfall will have to be met by the federal government.

If the changes to risk management and case resolution approaches that I have described are made, then we recommend that a plan be adopted by Congress that makes available the funds needed to meet the shortfall. This plan should:

-- provide for budget authority sufficient to finance case resolutions, which we believe can be completed over the next 3 years,

-- assure adequate controls over spending to protect the taxpayers' interests, such as by creating a control board, and

-- provide FSLIC with flexibility to undertake short-term liquidity borrowing to finance any deposit outflows that might occur while efforts are being made to determine resolution approaches for institutions placed in receivership.

To the extent that federal money is used, we recommend an on-budget approach that fully discloses the funding and outlays that are involved, even if this requires raising the Gramm-Rudman-Hollings deficit reduction targets. We also think that a restructured federal budget along the lines we have proposed elsewhere would better highlight the financing of FSLIC and similar enterprises that are set up to operate a business type cycle of operations.

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A Different Approach To Resolving Insolvent Institutions Is Needed

At the beginning of 1988 there were roughly 500 insolvent savings and loans with assets of about $140 billion. During 1988, the Federal Home Loan Bank Board began resolving these cases. The Bank Board acted on some 222 institutions, with most of the activity concentrated in the latter part of the year.

The willingness of the Bank Board to begin reducing its problem thrift caseload represents a much needed break from the practices of the past. But, we have serious reservations about the way the Bank Board proceeded.

In recent years the Federal government has been involved in several financial rescues. In 1984 we issued a report, based on the government's experience with Chrysler, New York City, and several other situations, about how such efforts should be structured.[1] This past experience underscores the importance of developing an adequate plan for financing, implementing, and overseeing these types of situations.

The Bank Board's actions have not been consistent with such an approach. The Bank Board has relied extensively on FSLIC assisted merger agreements that extend for up to 10 years. The notes and guarantees in these agreements provide a mechanism for coping with FSLIC's lack of funds and its lack of information on the financial condition of many of its insolvent institutions. Chart I summarizes the generic components of the deals.

As I noted earlier, at your request we are studying FSLIC's December 1988 transactions. We have not yet obtained all of the information we need and therefore are not in a position to comment in detail. However, we do have concerns about the nature of these agreements. These are summarized in Chart II.

-- Ownership capital contributed by private investors has been minimal, and large and thinly capitalized institutions are being created. If history is prologue, inadequate capital creates incentives for highly leveraged institutions to engage in unsafe and unsound management practices. These new institutions may, therefore, pose risks to FSLIC in the future. Should they become insolvent, FSLIC may find it even more difficult to fully resolve their situations because of their larger size.

-- The institutions resulting from the assisted mergers are heavily subsidized by FSLIC, and are competing with healthy nonassisted depository institutions at a cost advantage.

-- FSLIC provides capital loss indemnification and an operating

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[1] Guidelines for Rescuing Large Failing Firms and Municipalities (GAO/GGD-84-34, dated March 29, 1984).

subsidy on assets that appear to make it profitable to simply hold them. We therefore question the strength of the new institutions' incentives to actively manage and generate recoveries on those assets.

-- FSLIC faces a huge task in effectively administering these complex agreements.

-- Finally, it is questionable whether many of these mergers really save the government money compared to other options that would be possible if FSLIC had the money to resolve cases.

Another approach is needed that fully resolves insolvent institutions with no lingering adverse competitive effects on healthy thrifts or threats to FSLIC's finances. We recommend that:

-- FSLIC promptly take control of all insolvent institutions. These institutions should be placed in receivership whenever necessary until a decision can be made to liquidate or merge them based on a careful assessment of their asset portfolios, and the comparative cost of each resolution option. Of fundamental importance, these institutions must be effectively isolated from the rest of the depository institutions industry to prevent them from competing with

healthy institutions. Their operations must be limited to investing in high grade securities, managing bad assets on their books, and accepting deposits at prevailing market rates.

-- To accomplish this action, the assistance of state and federal regulators and insurance officials should be enlisted to quickly help assess the quality of assets in these institutions and make the necessary resolution decisions.

-- Arrangements should be made with FDIC for asset management and liquidation services until FSLIC can develop the requisite capability. FSLIC does not possess the infrastructure needed to manage the timely, cost effective resolution of all insolvent thrifts.

It is imperative that Congress reach an agreement about the FSLIC strategy as soon as possible. As things now stand, more of these merger agreements can be expected unless Congress acts to change FSLIC's strategy, reform the system, and provide the needed funds.

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I recognize that within the outlines of the actions I have suggested, there are many specific arrangements that need to be worked out. We are prepared to provide whatever assistance this

Committee and others deem necessary in developing the detailed plans for putting the thrift industry crisis behind us.

That concludes my prepared statement. My colleagues and I will be pleased to answer questions.

CHART I

GAO

Typical December 1988 Deal

- Note for negative net worth
- Guaranteed return on assets
- Guaranteed book value of assets
- Reimbursed certain expenses
- Waived regulation compliance
- Tax benefits
- Equity position in S&L

CHART II

GAO Concerns About Deals

Creates new thrifts that are:

- Thinly capitalized
- Have cost advantage over healthy S&L's
- Lack incentives to manage assets

May cost more than liquidation

Will require huge monitoring job because of complexity

The **Chairman**. Thank you. I am very interested and anxious to get into detailed questions. However, I'm going to yield to Senator Cranston. He has another meeting that he must attend and so I'm going to yield my time period to him and then after we rotate I'll follow Senator Cranston.

Senator **Cranston**. Thank you very much, Don. I appreciate your courtesy and I also want to acknowledge the fine leadership you're providing to the committee in moving this along as rapidly as you are, organizing these fine hearings and making plain we are going to do nothing else until we have resolved this matter.

I also want to compliment Kevin Gottlieb, the new director of the staff, who I think has done marvelous work on very short notice, along with all the other members of the majority and minority staff.

Just a very few questions before I have to run to a meeting with the majority leader.

You suggest that FSLIC must take immediate control of all insolvent institutions. Do you mean both GAAP, generally accepted accounting principles group, and RAP, the regulated accounting principles insolvent institutions?

Mr. **Bowsher**. Well, I think basically the 350 that everybody agrees are the insolvent ones are pretty much insolvent on the GAAP basis, but most of them would be insolvent I believe on the RAP basis. I don't think that's too big of an issue, Senator.

Senator **Cranston**. You don't think there's any problem about the fact that by law or regulation I believe that FSLIC is prohibited from putting a thrift institution into a receivership until it's both GAAP and RAP insolvent?

Mr. **Bowsher**. I think you can take control and put the reforms in there. We are very much against the RAP accounting that was used in the past. We really think it hid the emerging problem here and we really do recommend that part of the reform would be to use GAAP accounting.

FULL FAITH AND CREDIT OF THE U.S. GOVERNMENT

Senator **Cranston**. Do you see any reason why the full faith and credit of the U.S. Government should not be immediately and explicitly granted to FSLIC and FDIC obligations?

Mr. **Bowsher**. We have given a legal opinion at the request of Congress and we think it does have the full faith and credit.

Senator **Cranston**. You believe it does now?

Mr. **Bowsher**. Yes.

Senator **Cranston**. There seems to be some doubt in some places.

Mr. **Bowsher**. I think the doubt comes from the fact that Congress has not actually voted anything and the Justice Department has not been willing to give an opinion—or maybe they were not asked for it, I'm not quite sure. But I think that's what some of the lawyers and some of the accountants would like to see and I think that would be helpful.

But in our viewpoint, and our lawyers researched this very carefully, we feel that you do have the full faith and credit there.

Senator **Cranston**. If that was made explicit in whatever way necessary, would that reduce the ultimate cost of cleaning up the situation?

Mr. **Bowsher**. I think it would.

Senator **Cranston**. What do you think should be done to make it explicit so that we achieve that saving?

Mr. **Bowsher**. Well, I would think that if the Congress were to pass some kind of a resolution or the Justice Department was to give an opinion, I think that would be helpful.

One other thing though that they're worried about, Senator, is that there's no money available. Although the notes and the guarantees have the full faith and credit and Mr. Wall had the right to go ahead with them, the money is not available until appropriations are passed. So that is the other stumbling block. I believe that some of the people who are judging these deals and judging whether some of the actions are bona fide, that's what they are concerned about too. I think that gets back to providing the money as well as the reforms.

Senator **Cranston**. Because the Government has made this insurance available and with all the statements that I and other members of the committee, including the chairman and ranking member, have made, about nobody is going to lose any money, plainly the whole Government is involved.

Mr. **Bowsher**. There's no question.

Senator **Cranston**. Therefore, it seems to me the full faith and credit is there and if some action is necessary that would make that more explicit to some who are skeptics than it is now, it seems to me, Mr. Chairman, that's one action we should consider trying to get accomplished now which would reduce some of the long-range costs and would not interfere with finding reforms along with money in due course.

Mr. **Bowsher**. If I could make one other comment on that, though, you might want to consider some kind of a cap on these deals that are being made or considered at the same time you do that. That's what we recommended last spring and I think that would have helped keep this situation under more control. So the two of them might be very useful.

Senator **Cranston**. Your analysis of the deals that were made in December and late last year is very, very interesting and I think it's obviously possible to criticize some of the ways that those were accomplished. Yet, on the other hand, I think that the criticism has to be pretty broad. FSLIC didn't have too many choices, given the fact that we did not make money available to them.

Mr. **Bowsher**. That is very true, Senator.

Senator **Cranston**. I'd like to ask you one question for which I'd like just a written answer, not verbally now. I have a list of 17 thrifts that were put in the Southwest plan from the Federal Home Loan Bank Board that purports to show how much they saved over the cost of liquidation by using the Southwest plan approach, combining a group of S&L's with very little capital initially to reduce the cost of funds used mostly in economically depressed areas. I'd like you to take a look at those numbers and give me your comments subsequently in writing on them.

Let me just say one more thing. I think there's been some misconceptions concerning the Robert Bass purchase of American Savings in Stockton, CA, the misconception being that it was a Southwest plan deal. I just want to clear the record that the Bass transaction really is a good bank-bad bank transaction where all the bad assets were removed from the original thrift and put in a separate entity to be managed by the Bass group. In fact, that's exactly the way GAO has recommended that the new FSLIC be structured. The Bass deal was the first deal of that kind and I want to make sure that it's not lumped in anyone's mind with those other transactions.

Thank you very much.

The **CHAIRMAN**. Thank you, Senator Cranston.

Senator Garn.

Senator **GARN**. Thank you, Mr. Chairman.

Before Senator Cranston leaves, he made a point that I wished to make that I think is very valid and I wish that more people would listen to. I don't disagree with your criticism of many of the December deals, but I think we have to look at them in the light of the tools that were available to FSLIC and any of us in that situation—faced with the fact that Congress didn't give FSLIC the recap that Senator Riegle tried to help me pass and did pass in the Senate in October 1986 with no limitations. With Senator Proxmire's leadership last year, we did approve $11 billion of full faith and credit for FSLIC notes with a cap on it, as you suggested. The House would not go along. So the Senate did try as early as 2 years ago and 1 year ago to take some actions which the House would not go along with. We not only didn't give them new tools in October of 1986, we even refused—or the House did—to extend the emergency provisions of Garn-St Germain which expired on September 30.

So I think we have to look at the December deals in that context. It's easy to criticize, and I can agree they are thinly capitalized and I wish there had been more outside capital put in, but the choices that were available were limited—keeping them going and not having the funds to shut them down. If we had had the funds we'd just say let's close them down and liquidate and pay off the depositors up to $100,000. That would have been a much better option. I appreciate your bringing that out because the options were rather limited and that makes the point that we are all making here today, that we need a combined package and we agree with you completely on that—not new infusion of money without reforms—and we need to do it as quickly as possible so that we do give the Bank Board the opportunity to make much better deals than they were forced into in December because of not having the tools available to them.

That brings me to my first question. In your testimony you do suggest that FSLIC promptly take control of all insolvent institutions. The question I have about that is how is that good? We could do it. My question is how would FSLIC pay the cost, first of all, with that action?

Mr. **BOWSHER**. Well, I think what we're saying is that when you do that you've then got to have the money to work out the situation. In other words——

Senator GARN. Then the answer to my question is simply—we agree that that ought to be done, but it can't be done unless we pass the reform package and have the money in order to do it?

Mr. BOWSHER. That's basically true, Senator.

Senator GARN. I just wanted to get that.

Mr. BOWSHER. And we were talking about the 350 thrifts that are left that were not part of the deals. That's what we were recommending there and we recommend that as part of the reform package.

Senator GARN. My next question was, OK, you take them over, but how do you stop the hemorrhaging? In your testimony, you said put this in place first and then take them over because you wouldn't stop the hemorrhaging—that's the same situation as December—without the tools unless you curtail their activities and immediately take them over.

Mr. BOWSHER. You've got to have the reforms. You've got to have the tools, as you call them, and you have to have the money. There's no question about it.

Senator GARN. The next question that I would have then is the practical matter of where do you find the management and other employees necessary to run 350 institutions?

FINDING MANAGEMENT FOR INSOLVENT INSTITUTIONS

Mr. BOWSHER. That's why we recommend one of the things to be considered is an administrative merger, you might say, with the FDIC because we believe that they have substantial staff over there. They have been doing a large number every year and we think that that could be helpful. We think also there are other talents and other staffs in the Federal Government that ought to be looked at. It would take a large staff but we feel a real effort should be made to enhance this staff, to do the job that has to be done. And the sooner you can do that, enlarge staff—and we've checked this out with the FDIC—in other words, they think there are possibilities for this and Mr. Seidman has even recommended it himself—then I think you would start to get on top of the problem and start to stop the hemorrhaging.

Senator GARN. The reason I asked the question the way I did and put in the phrase "as a practical matter," is that several years ago we decided it was necessary to try to beef up staffs under the current regulatory structure. One of the things that was done that probably should be changed now was to defuse the regulatory authority of the Bank Board so that you could avoid the pay caps imposed on Federal employees and pay enough to try to attract the kind of talent necessary to compete with the bright ones out there in the institutions who are paid a lot more and have been there for a long time.

So I don't disagree with you on the need for increasing that staff. It's just that suddenly if you instantly take over 350 institutions, as a practical matter, it seems very difficult to quickly find the talent to supervise all of those institutions.

Mr. BOWSHER. Yes. That's why—as Fred is telling me here—that is why we would want to restrict what those institutions can do because we know you can't do it all at one time. But I think if you look at what the FDIC has been able to achieve in the last 2 or 3 years addressing the problems they have been facing that basically was their approach. They had the money in the insurance fund so therefore they could go out and do it and they had a staff which they had beefed up.

Now I think another issue that comes up here as part of that is if you separate FSLIC from the Bank Board and have independent insurance funds—maybe a good fund-bad fund over here, and also then the FDIC fund—then do you put them under the same budget constraints as all other Government agencies? And it gets back to the Gramm-Rudman process and who's included and who's not. I think Mr. Seidman has recommended that this is a trust fund, that this is more of an enterprise fund, and they should be able to have more leeway in salaries and have more ability to hire the staff that is needed to get the job done. This should be considered as part of the reform package here, too.

Senator GARN. I would agree. I think you have to have some salary differentials to try and attract people that are necessary to solve this problem.

Mr. Chairman, my time is up. Just one quick comment. The term bailout is used by all of us. It was used by you today. The point that needs to be made when we talk about bailouts, is that it is depositors who have been bailed out, not management and not stockholders. I think that is a very significant difference. It is getting back to what both the chairman and I have talked about—the full faith and credit. So it's different in that sense, Mr. Bowsher.

Mr. BOWSHER. It is different, but I would also point out in those other situations we did not bail out the management and we generally insisted on management changes and many of the stockholders lost.

Senator GARN. That's true. Many of the stockholders did. But in this case, the stockholders have been losing money and management has been wiped out. I just think it's important to note that we're engaged in a bailout, if we want to use that term, but it is bailing out the depositors because we made a commitment of the full faith and credit of this Government to do that.

Mr. BOWSHER. We agree with that 100 percent, Senator, and often you'll see stories like I saw in one of the newspapers here a week or two ago, a poll around the country as to whether we should bail out the S&L's. The point they missed was the one that you just are making. That is, this is a legal liability of the U.S. Government to the depositors.

The CHAIRMAN. If I may, just following on with that, I agree with what's just been said, but there's another part to the story, as is often the case. That is, an awful lot of people got rich in the process. Now we're talking about restoring the money that depositors put in. But the other side of it is, where did all the money go? And the money has gone into deals that didn't work out. People got rich in the process. We're going to look at the fraud issue next week. Stories have appeared in magazines and national newspapers about the executives of some of these savings and loans who paid themselves enormous salaries, took huge frontend fees on deals that later turned sour. They made off with the money. That money is probably in fine works of art or yachts or great houses or limousines. But there is another side to this coin in terms of where the value went. The S&L's initially invested in real estate projects now undervalued. Some are now finished, some unfinished. But the money that was lost just didn't vanish into thin air. It went somewhere. We have a responsibility to pin down where it went. I know the Justice Department also has an interest in finding out. In fact, the Secretary of the Treasury himself as recently as yesterday said that an effort should be made to go out and recover every dime we can get. I very strongly support that objective.

Mr. Bowsher. I think that's very true, Mr. Chairman. As you know, we have also reviewed some of these from that vantage point and we have been very surprised how much fraud and insider dealings were involved in some of the loans that we were asked to look at.

I might also point out one other thing and that is, in the December 1988 deals, we are really guaranteeing more than the depositors. In other words, part of those guarantees are going to accrue to management, to stockholders. It's a new setup. It's new management and everything like that, but that's something we have created with these approaches.

Senator Garn. Mr. Chairman, I don't want to prolong the debate because it really isn't a debate. I just wanted to dispel the notion that the bailout is bailing out bad management and fraud and insider abuse. That is not the case. The chairman is exactly correct, and a good example is the situation in Maryland in that State-chartered institution we all read about that where the chairman of the S&L is in jail and his houses and cars were all taken away. The chairman is correct that to help solve this problem we ought to try to recover as much of that money as we can have where there has been criminal misconduct. We ought to get it back from those people.

The Chairman. Well, to return to the December deals, I think you have made a very important observation for us, the full meaning of which still is not completely clear. It's going to take a while to really wade through these massive amounts of paper associated with the deals. We were told in our hearing on Tuesday that typically the finished documents represent a stack of papers that may be 18 inches high, deal by deal. So, as you go back through the paper work to reconstruct what happened and the financial implications of what happened a very time-consuming, and very difficult process, is it not deal by deal?

Mr. Bowsher. It very much is. The way we're approaching it is looking at a number of the deals to see what they are like. At this point we cannot look at all of them until we see what they are made up of. I think that points out the last item on our chart too. That is, it's going to be very difficult to monitor these deals. In other words, it's going to take a lot of talent to monitor how these deals are working out. Some people I know are concerned about the amount of lawyer fees, accountant fees, tax accountants and everything like that that is involved. From what we can see, you're going to have to do quite a bit of for a number of years.

The Chairman. Well, I must tell you about monitoring a story that you may have seen on the front page of the Wall Street Journal about a lawyer who is now in business of putting these deals together. He used to work at the Federal Home Loan Bank Board and apparently took a very active part in the move of deregulation that which in part helped cause this problem. Last year, that lawyer, if the story is accurate, did $12 million worth of private legal billings in these deals. That kind of anecdotal information is very troubling to me. I'm hopeful that we will find out where the money went and how much of it can be retrieved. There was an individual in Maryland who was involved in that State's S&L crisis who went to jail. There may be others elewhere that ought to be apprehended and made to return the money.

Let me ask you this specifically. My understanding is that FSLIC did not do its own due diligence review before entering into these December deals and thus was not in a position to know the true financial condition of many of the institutions involved. Is that correct?

Mr. BOWSHER. We're not sure to what extent the due diligence was done. We're looking at some of that right now, but we are concerned that many times they did not have as much information about the situation as you would hope they would when they were making these kinds of deals.

The CHAIRMAN. Multibillion dollar deals.

Mr. BOWSHER. Multibillion dollar deals.

The CHAIRMAN. Are you having any trouble getting information from the Bank Board in response to the request that you received from this Committee?

Mr. BOWSHER. We're getting pretty good cooperation, but needed information is sometimes hard to obtain. One thing I would like to point out, though. Somebody mentioned it earlier. That is, we're going to get detailed cost information from the Bank Board of the different situations. We work with that every year, as we do the financial audit of FSLIC. Last year we went through it bank-by-bank and added to the reserve at that time. What's happened here as we look at these deals is that the cost is double what they thought it would be last spring. We're going to be looking very carefully at what the reserve numbers are this year.

The CHAIRMAN. Senator Mack.

Senator MACK. Thank you, Mr. Chairman.

I want to follow on with a couple of points that were raised, one specifically having to do with the 350 institutions that under your proposal would be supervised by the FDIC.

I have some real concerns about what impact that might have.

IMPACT OF FDIC SUPERVISION

Mr. BOWSHER. We are not saying that they would be supervised by the FDIC. It's more of a merger of staff in that they would work under the direction of the new FSLIC. Whatever the legislation would create, they could utilize some of FDIC's staff and staff from some other organizations. The leadership would come from the insurance fund that's handling the S&L's.

Mr. FOGEL. Senator, let me explain what our proposal would do is put them under the control of FSLIC but they would still be open as S&L's. People could keep their deposits there. We wouldn't assume that you would liquidate all of the assets immediately. You would take a look at the assets. You would try to figure out over a 2 or 3 year period what to do with the assets.

But in the meantime, you would restrict the type of activities they could get involved in to basically ones that are much more conservative and allow them to pay their depositors the normal rate of interest that S&L's pay. So they wouldn't necessarily all go out of business.

Senator MACK. I understood that, but let's assume that they stay in business for some period of time. Again, someone would be supervising them and I guess I got the feeling from what you were saying that that would be FDIC.

Mr. BOWSHER. No. We're saying more that the Board staff would use staff from the other agency and that FSLIC would be the lead insurance agency.

Mr. FOGEL. They would still be supervised by FSLIC but we would like to see as part of the reform package FSLIC be made independent of the Bank Board. But what we were saying is, given the number of institutions that we would have to go into, FSLIC work with FDIC to get some people into these banks to really go over the type of assets that they have. If you decide to liquidate them, FDIC has a fairly large operation that is involved in liquidation and has a lot of experience in doing that. So we'd like to see the two groups work together to work these out.

Senator MACK. So what you're saying is neither you nor FDIC feels that they have a problem with a drain on their resources to continue to do their job with respect to supervising the Nation's commercial banks.

Mr. BOWSHER. Well, I think what they feel is that this problem is so large and growing, at whatever rate, that it would be useful to use of some of their resources. And I think they also feel that some of their problems are starting to trend down, you might say, especially among the smaller banks where they had to use a lot of their resources. So they feel that they could be part of the effort here if the Congress made a decision to go forward with this kind of a solution.

Senator MACK. But also a little bit earlier I think in response to Senator Garn's question, you had indicated a need to enhance them.

Mr. BOWSHER. Very definitely. Then you should also be enhancing the FSLIC staff at the same time, which they have been doing actually. They have been doing that here in the last few months.

Senator MACK. Let me just move to your review of some of the deals that took place before the end of the year and Senator Cranston mentioned the Bass transaction. Did you have an opportunity to review that? And number two, in the process of looking at these different deals, did you find any that you felt were well-structured, that could, in fact, serve as a model as we move forward to trying to solve some of the problem?

Mr. BOWSHER. Why don't I have Fred Wolf answer your question here, Senator?

Mr. WOLF. Both of our groups are looking at these deals. I am generally familiar with the Bass deal, and I would agree that it is different than many of the other transactions that have been done.

I don't yet have enough details to say specifically, yes, good deal or a model, or anything like that.

Senator MACK. Do you have an instinctive reaction as to whether it is a better deal?

Mr. WOLF. There are some elements of it that appear to be a little bit better, because they have clearly isolated the bad assets in a work-out institution and then have a good bank, if you will, to go forward for the future. But I don't think we are in a position to say a great deal more about that one at this point.

Senator MACK. How about the tax consequences of the deal?

Mr. WOLF. There are tax elements, but I don't think we have got enough to say at this point.

Senator MACK. Again, how about the other part of the questions. Did you find any transactions that you felt were a model that should be followed?

Mr. BOWSHER. We have not been able to get into them far enough that we would want to say that we have a model at this point.

Senator MACK. And let me just ask you, how many of these transactions did you look at to come up with that this is a typical transaction?

Mr. FOGEL. We have got the outlines of most of them. We are going through in detail right now between half a dozen and twelve transactions. The outline of the problems that we've identified was based on a cursory analysis of most of them, fairly extensive discussions with the FDIC people involved—I'm sorry, the FSLIC people—involved in the deals, as well as some of the groups that were involved in the negotiations.

Mr. BOWSHER. I might also point out, Senator, that some of these concerns, of course, that we have highlighted here are shared by some of the staff over there. In other words, they know themselves, and they pointed out to us what were their concerns. So it isn't that we have a big debate on the issues either.

Senator MACK. Did they have a reaction to the Bass transaction?

Mr. BOWSHER. We have not delved into the Bass one at this point.

Senator MACK. OK.

Mr. BOWSHER. So we just can't confirm or deny it.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

In your testimony, I believe you advocated allowing qualified thrifts the option of choosing between FSLIC and FDIC. I see that the line of reasoning behind having an option seems to be to go ahead and examine the demand for FSLIC insurance and thus the demand for a separate thrift industry.

Do you believe that the trends that we are going through in finance, the problems we have had with the thrifts and everything, shows that there is a diminishing role for thrifts in the origination of home mortgages? Do we really need a separate thrift industry and what do you really mean by your options?

OPTION OF CHOOSING BETWEEN TWO INSURANCE FUNDS

Mr. **Bowsher**. Well, we believe that the moratorium should not be on there forever. In other words, we think that the healthy thrifts at some point in time, and I would think a good time would be either when the moratorium ends this year or if the legislation can be passed by the Congress, then it seems to me they should be given the opportunity to decide themselves.

Senator **Shelby**. To exit, in other words.

Mr. **Bowsher**. Yes. And then I think you will get a much clearer view as to how much need there is for these separate savings institutions.

Senator **Shelby**. Basically, what do you determine is a healthy thrift or qualified thrift?

Mr. **Bowsher**. Well, they are working on that now and have issued a set of criteria to improve the health of thrifts, including capital requirements, up through 1993, roughly. In other words, it is a transition plan, which I think makes a lot of sense, because I don't think you can change them all in a year. But they are asking for capital requirements not too dissimilar from the banking industry's on a GAAP basis. And I think that is very good. That is the kind of a trend and reform that ought to be in place so that we don't end up with this kind of a situation 10 years from now.

Senator **Shelby**. Don't we actually have a number of large thrifts in the country if they assume they were qualified or healthy, and they made that exit, there wouldn't be a lot left, would it?

Mr. **Bowsher**. That possibility is there, I think, Senator. We just don't know whether they will make that individual decision.

Senator **Shelby**. So, in your testimony, you are advocating the option anyway.

Mr. **Bowsher**. Yes. We don't think that the Government should force institutions to stay in one group or another forever. We can see some merit in why it had to be done under the circumstances, but we believe, and I would think again that this might be part of the legislation here, that once you have a reform package, once you have enough money here to start the work out situation, that then, at some point in time, you would allow those thrifts to make their choices as to which group do they want to be in.

Senator **Shelby**. How much money—assuming one was a—oh, a good-sized thrift, a billion dollars or so, a couple of billion dollars, how much money would they save in the premium insurance by going to the FDIC?

Mr. **Bowsher**. Well, right now they are paying about twice as much as what a bank is, and if you were to continue the special assessment, then you would still have that situation. But again, that would be one of the things that the legislation would look at.

Mr. **Fogel**. If they did move over to the FDIC fund, they would still have to pay the normal contribution, about 1 percent of capital, into the Insurance Fund. So that it would cost them something initially.

Senator **Shelby**. As an exit fee?

Mr. **Fogel**. As an exit fee. The other thing, though, as part of the reform package we are recommending, is that the healthy thrifts have to capitalize the healthy S&L insurance fund, so they would have to pay some contribution to capitalize the new FSLIC insurance fund.

Senator **Shelby**. Last, do you have a recommendation where we are going to get this money? I mean, you know, it's not going to come out of thin air.

Mr. **Bowsher**. We think it is better to do the financing through the Treasury rather than issuing special bonds, because it is the least cost to the taxpayer, and we believe it should be on budget and should be within Gramm-Rudman targets, even if it means that the targets might have to adjust. In others words, we don't think that we have a situation here that we should be doing blue smoke and mirrors to try to show that it is less costly than what it is.

Senator **Shelby**. We face the issue head on.

How much money per year do you think that is going to cost? $10 billion up?

Mr. **Bowsher**. Yes. We were asked that by the Budget Committee last week, and I think it would be better to get the administration's plan, to get the OMB figures and to have CBO's, and we would be happy to review it if the Congress would like us to do it.

Senator **Shelby**. And come back again.

Mr. **Bowsher**. And come back, yes, and look at it at that point rather than give figures now.

Senator **Shelby**. Thank you, Mr. Chairman.

Mr. **Bowsher**. If I could just add one thing though, and that is that I would strongly urge that whatever the numbers are in the first couple of years, they would be enough. I think maybe Senator Garn pointed out the best today that this has been one of our problems. In other words, whenever we had any kind of a solution that the budgeters were willing to include, it was generally smaller than what the problem was. And I don't think now we want to repeat that.

If I could point out more thing, Senator Shelby, to your first question, and that is, we looked at this whole situation, and we couldn't come to any conclusion whether you still needed the thrifts. You have to recognize that the thrift industry is still generating almost half of your home mortgage originations. So you well might need thrifts, but I think allowing them to make a choice where they want to be, could indicate some kind of a private sector option here.

Senator **Shelby**. But they could still provide this same service,

Mr. **Bowsher**. I think many of them could.

Mr. **Fogel**. One of the reforms we recognize, though, is that there be greater consistency between banks and thrifts in matters pertaining to powers and operations that materially affect the deposit insurers' exposure to risk. So what we are saying is, as part of the reforms, you might want to bring the powers and operations that both groups can engage in into a little closer convergence.

Senator **Shelby**. What impact does the securitization of mortgages have on the need for further savings and loans?

Mr. **Bowsher**. Well, I think it has an impact, but we have not studied it, Senator,

Senator **Shelby**. OK.

The **Chairman**. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

Mr. Bowsher, let me first commend you again, as Senator Wirth and others have, on the excellent contribution you have made with this and many other reports, and we hope you keep them coming.

Mr. BOWSHER. Thank you, Senator.

Senator HEINZ. Now, as I would summarize your report and your testimony, perhaps a little rhetorically, the FSLIC went on a spending spree at the end of 1988 and has run up its credit card to the point where it can and it will spend all its income for the next 10 years, and then it will still have by your estimate an outstanding balance of some $26 billion; is that right?

Mr. BOWSHER. That is our best estimate at this time.

Senator HEINZ. Now would you say, therefore, that the FSLIC has run out of credit?

FSLIC'S CREDITWORTHINESS

Mr. BOWSHER. Oh, no, I think they can probably do some more, because, see, the deals are being put together on a present value analysis, and so you can make the deals now. You don't have to come up with the cash. You can do more notes; you can do more guarantees. So I think if they wanted to continue, and they could find people willing to do it, you could see more deals here in the coming months.

Senator HEINZ. Do you think the FSLIC can creditably close thrifts in 1989 on the same basis as they have in December?

Mr. BOWSHER. I think they could make more deals. The only difference would be in the tax area. They only have 50 percent now, I believe, rather than the 100 percent. But other than that, the conditions have not changed.

Senator HEINZ. Did you indicate at the House hearings that the FSLIC had gone beyond what was characterized as an express promise not to spend more money than it can generate over the next 10 years?

Mr. BOWSHER. Yes. We think that when you get the cash flow paying off these deals that you will run into a need for additional funds.

Senator HEINZ. I am going to discount a lot of what you said in your first answer, because the present value of income in years 11 and out is very small, indeed, to close deals now. The liabilities that the FSLIC has incurred are liabilities that they are going to have to face on a present value basis within the first 10 years. I would urge you to go back with your fine pencil and just consider whether you want to refine the answer you just gave me on the extent of the FSLIC's ability to continue to resolve deals, because I suspect, mathematically that you are incorrect.

Mr. BOWSHER. I may have misunderstood your question. I thought it was whether they could still make these kind of deals.

Senator HEINZ. The question was whether they have the financial capacity and creditworthiness and credibility in the marketplace to do that.

Mr. BOWSHER. Yes. All right. I'll go back and take another look, but I think they have negotiations going on right now, and I wouldn't be surprised that unless the Congress acts to put some kind of a cap on it or comes through with a new plan, they will continue to make deals similar to what we have seen here.

Senator HEINZ. There is a reliable indicator, which is the discount at which the FSLIC has to sell its notes. As I understand it, that discount is getting high, not smaller, which indicates to me that the market is making a judgment that FSLIC does not have the credit to make more deals.

Mr. BOWSHER. Well, I think that is probably true.

Senator HEINZ. Well then, that fact is somewhat different, it would appear to me, from your judgment.

Mr. BOWSHER. Perhaps, Senator, I could explain a little bit without getting into a lot of complications. What we estimate is that—and I want to stress that these are estimates, these are ballpark figures—the cash requirements over the next 10 years to resolve the 88——

Senator HEINZ. Can I ask another question?

Mr. BOWSHER. OK.

Senator HEINZ. I've only got 5 minutes. Do you want to put that response in writing?

Mr. FOGEL. OK. We'd be glad to do that.

[The following information was subsequently submitted for the record:]

FSLIC already has obligations outstanding that exceed the resources currently available. In that sense, FSLIC has indeed exhausted its financial capacity. However, one thing that has, to a great extent, played a role in FSLIC's ability to issue notes is the general belief that the Congress will make good on FSLIC obligations.

There have been questions raised regarding the accounting treatment of FSLIC notes that could make the market hesitant or even unwilling to purchase FSLIC notes. However, until and unless the market is unwilling to purchase FSLIC notes, and absent the Congress placing some sort of limit on the amount of obligations that FSLIC can have outstanding at any one time, FSLIC can probably issue more notes.

Senator HEINZ. Let me go to my next point, because I've got a lot of ground that I would like to cover and very little time.

Let's say, hypothetically, that, indeed, the FSLIC is in a bind. Maybe it is not, but let's say it is. Let's say that the Congress really has a sense of urgency, but we don't have a sense of courage equal to our sense of urgency. This, of course, is unheard of. [Laughter.]

Let's assume that we decide to bite somewhere between half to one-third of the bullet, in terms of the money, but we also decide that we are willing to bite half to one-third of the reforms. You've given us a long list of reforms. Assume that we will have to come back and bite the rest of the bullet and the rest of the reforms later. Which would be the most important reforms for us to bite right up front?

Mr. BOWSHER. Could we give that some thought and maybe supply that for the record?

[The following information was subsequently submitted for the record:]

We believe and continue to stress that Congress should only adopt a plan to pay FSLIC's bills in conjunction with necessary reforms to minimize the chance that the current FSLIC situation is repeated. To that end, higher capital requirements, better adherence to rules for closing insolvent institutions, better supervision of problem institutions, and more flexibility in setting insurance premiums are all needed.

To most effectively implement these reforms, the first things Congress should do is change the regulatory structure to make FSLIC independent, and provide both FSLIC and FDIC with the authority needed to better ensure the soundness of the deposit insurance system. Congress should also direct the appropriate agencies to establish consistency in regulation and supervision of banks and thrifts in matters that have a material effect on the government's exposure to deposit insurance losses.

Senator HEINZ. All right. Let me ask you one last question before my 30 seconds retires here.

You mentioned the Chrysler bailout. I remember that very well as a member of this committee. I offered an amendment on the floor to require that the taxpayers get any of the profit from the Chrysler bailout which became the warrants. I thought it was not only important to protect our financial interests, but if anyone was going to profit from the largess of the Government that it be the taxpayers.

Now is there any similar means whereby, if the healthy part of the industry prospers and survives, makes money, grows rich, fat, healthy and wealthy like we would all like the healthy ones to do because they haven't done anything wrong; we can protect the taxpayers or get the taxpayers a better return on their investment than just putting money into the sick S&L's, irrespective of the reforms?

Mr. BOWSHER. Yes. If they could put the other chart up there, you see that warrants are a part of the typical deal. So I don't know whether they learned that lesson from the Chrysler situation, which was the first time we ever used it——

Senator HEINZ. Those are the deals with the sick S&L's I am talking about the healthy part of the industry which I assume is going to be made healthier by anything we do. If we do nothing, the entire industry, ultimately, although we will protect the depositors, will simply disappear, because the FSLIC will be forced to increase premiums to the point where no one will be able to remain in the industry. They will all go out of business, and we will have a larger liability. But we will pay off the depositors. In the alternative, the industry presumably has a shot at becoming healthy. Maybe 10 years from now the healthy S&L's will be extraordinarily wealthy. My time has expired, and I leave it up to the chairman how he wants to proceed.

The CHAIRMAN. Do you have a brief comment you want to make?

Mr. BOWSHER. Well, I would just say that we have not given much thought to the healthy ones, but we were pleased to see that the warrant feature was in the typical deal, and we will give that some thought. But I think that you've got to recognize that if you get the unhealthy ones out, the industry does have a possibility of coming back, and one of the things we have put in our estimate is funding to create that new insurance fund that could protect the healthy thrifts in the new industry, you might say.

The CHAIRMAN. Before recognizing the Senator from Florida, Senator Graham, let me observe that I like the concept. It worked well in the Chrysler rescue. We made a lot of money. The taxpayers profited handsomely in many respects on that deal and the country came out ahead. There is this problem, however, in the Government taking a partial ownership position in a regulated industry. Then the Government would be regulating the very entity that it partially owns and you have a built-in conflict of interest. A question arises how the Government would handle that conflict of interest—whether it would blow the whistle on its own institution when necessary, or whether it would be inclined to say, let the problem ride a little longer. Maybe it would work and the Government would get a bonanza?

Senator **Heinz**. Mr. Chairman, there are some very good answers to that, and we can discuss those another time.

The **Chairman**. Very good. Senator Graham.

Mr. **Bowsher**. If I could just add to that a little bit. I served on the Chrysler Loan Board, of course, at the end when the warrant thing came up for final resolution. You do have some of those pressures. We did, even in the Chrysler situation, but at the same time, I think for the Government to have some kind of an equity position made a lot of sense in the Chrysler situation, and I am kind of inclined that maybe it does here too.

The **Chairman**. It is a good subject for debate, and we will take a good look at it.

Mr. **Bowsher**. Yes.

The **Chairman**. Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman. I would like to focus on the issue of the sliding institutions. You have identified the cost, page 26 of your testimony, at $26 billion for those 88 institutions on which action was taken in 1988. Is 88 the correct number?

Mr. **Fogel**. No. It was in 1988. It was about 220 institutions.

Senator **Graham**. And then the 350 institutions which you describe as insolvent but were not dealt with.

Mr. **Bowsher**. That's correct.

Senator **Graham**. What is your assessment of institutions which do not fall into one of those two categories but have, for instance, less than the prescribed capitalization?

THINLY CAPITALIZED INSTITUTION

Mr. **Bowsher**. I think if you take the issue of good will, which is another issue that people are looking at and have to look at, and remove that, why you might have another 100 institutions that could slide into the 350 if you got bad economic times of any sort and things like that. So you probably have 100 institutions that are in the next category that people have to be worried about.

Senator **Graham**. And it is to those hundred institutions that you have attached the $5 billion figure.

Mr. **Bowsher**. That is correct.

Senator **Graham**. Are there any actions that the Home Loan Bank Board or FSLIC could be taking administratively now in order to reduce the likelihood of insolvency or reduce the cost of that insolvency to the Fund?

Mr. **Bowsher**. Well, I think the plans that they have put into effect now to improve the capital requirements, moving toward more GAAP basis accounting and things like that, are the right direction. In other words, I think they are moving on it. And as Fred Wolf reminds me here too, they are trying to improve the regulatory oversight and everything like that. So I think they are moving to try to hopefully not have those 100 slip into the bad situation, and we think that the things that they are doing probably make sense.

Senator GRAHAM. Is the answer that there is no action beyond that which is currently being taken that you would recommend?

Mr. BOWSHER. Let us go back and look at that one more time, Senator, and we will supply it for the record, if there is some additional ones that we think of.

[The following information was subsequently submitted for the record:]

The Bank Board has passed or proposed many regulations that have the potential of reducing the likelihood that institutions will become insolvent. The fact of the matter is, without an adequate source of funding and staff to shut down institutions that are presently insolvent, and take action against institutions that operate in an unsafe manner, the regulations that the Bank Board has passed or proposed can not properly be implemented. Once the funding and personnel capability is in place, then actions that the Bank Board are currently taking, as well as other actions such as the ones we have recommended will be more effective.

Senator GRAHAM. One aspect of that, the question of staffing for FSLIC.

Mr. BOWSHER. Yes.

Senator GRAHAM. You recommend that there be utilization of other competencies specifically on pages 11 and 12 with reference to FSLIC. Would that not be within the administrative capability of FSLIC to enter into the arrangement you suggest with FDIC, in order to get additional staffing?

Mr. BOWSHER. Yes, I think they could do that.

Senator GRAHAM. Do you have any indication of their intention to do so, and if not, why not?

Mr. BOWSHER. I think they've had some discussions, but we don't have any indication of a decision. Do you have?

Mr. FOGEL. No, we don't. On of the factors that you would have to take into account as to whether they want to enter into such an agreement is, what do you want to do with the 350 that are out there that are still in business that we haven't yet decided whether to, in effect, put in receivership or take them over.

Senator GRAHAM. But I am talking about the question of getting the human resources to do whatever they——

Mr. BOWSHER. Yes. But see what Dick is saying there is that they are really waiting to see, I think, what the Congress is going to do, and is the Congress going to want more of the deals like this, or are they going to want to do more what we are recommending—and what some other people are recommending—which is getting control. You need different staffs to do those two approaches. So I think that once they have an idea which approach is going to be adopted by the Congress and what other reforms and structure reforms and that, I think they would get into a negotiation very quickly.

Senator GRAHAM. You remember as one of your first priorities the separation of FSLIC from the Home Loan Bank Board, and then you call for the division of FSLIC into two separate funds—a healthy fund and a sick fund.

Mr. BOWSHER. That is correct.

Senator GRAHAM. Could you describe in some more detail how you would see those funds being capitalized and managed by FSLIC?

Mr. BOWSHER. Well, we think that thrifts that are in good shape are the ones that should—as they send in their premiums—build up this $20 billion of the reserves. Now you might want to put an additional capitalization in as part of the deal, but basically their insurance premiums would be used, literally, for the new reserve, and that would be for the good companies. And then over on the bad company ones, that is where you would need the money to actually work out the situations after you have taken control, and that would be supervised as a bad company group under certain limitations and things like that.

And we think that the FSLIC should be removed from the Federal Home Loan Bank Board because of the issue of getting the advocacy group away from the independence that you need in the regulation, the supervision, the auditing and the insurance.

Mr. FOGEL. One point, Senator, the bad or the sick company fund would probably have to be funded someway or another by the taxpayers because those S&L's don't have any money now to put in there.

Mr. BOWSHER. Yes. You have 350 insolvent S&L's in that group.

Senator GRAHAM. Yes, It really is somewhat of a misnomer to talk about the fund for the sick institutions as being an insurance fund. I mean, it would be like selling insurance to corporations.

Mr. BOWSHER. It is a workout fund.

Senator GRAHAM. Yes. Mr. Chairman, I would just like to make one last request. On January 31, I introduced two bills, one S. 287, which would call for a division of the Home Loan Bank Board and FSLIC, and S. 288, which calls for variable premiums, which would seem to be similar to your recommendation on page 5. I would appreciate if you would look at those two pieces of legislation and make any recommendations.

Mr. BOWSHER. Sure, I would be pleased to do that.

The CHAIRMAN. Thank you. Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman. Mr. Bowsher, what estimate could you give us of the current value of the net worth of the healthy institutions in the savings and loan industry? The last figure I saw was that about 90 percent were solvent and about 60 percent were profitable. Now that changes from day to day but can you give us a ballpark estimate of how much the industry is worth?

Mr. WOLF. The solvent piece of the industry?

Senator GRAMM. Yes.

Mr. WOLF. The solvent savings and loans as of September 30 had roughly $1.2 trillion in assets, deposits of $850 billion and capital on a GAAP basis of $58 billion, and $65 billion on a regulatory basis.

Senator GRAMM. So depending on how you wanted to do the capital, they have got roughly between $60 and $30 billion?

Mr. WOLF. Yes, about $36 billion is on a tangible basis, so the good will is out of that.

Senator GRAMM. You have two statements on page 7. The first statement is, "We believe the thrift industry should pay as much of the shortfall as possible." And then at the beginning of the next paragraph, you say "Under the best circumstances, it is not likely that the thrift industry can contribute much more to the funding of the shortfall."

How much is "much more"?

Mr. **Bowsher**. We are not sure. What we are really saying here is—and many of you on the committee have said earlier—you've got to look at every source of contribution here, as you work out this situation and nobody should be just automatically excluded in that. So we think you have to look at the industry itself.

At the same time, the second sentence is trying to alert everybody to the fact that we don't think there is a lot of potential money there.

Senator **Gramm**. Well, you just told me there was $30 billion even by current value accounting.

Mr. **Wolf**. If you take all of the equity of all of the institutions, you will put a whole pile more into insolvency who have depositors, and we will have to bail them out.

Mr. **Bowsher**. Yes. And what we have put forward is the idea that you would look to them to build up this reserve for the new healthy group. And that would probably require a premium for sometime, not too different than maybe what they are paying now and they are paying twice what the banking industry is paying. Then Fred's point is very valid, and that is, you want to make sure you don't put a package together here that starts to push people down into the insolvent group.

Senator **Gramm**. Let me ask another question. You talked about the uncertainty as to whether you would have been better off just to liquidate the savings and loans that have gone through the Southwest plan. If your choice were between the deals you looked at or simply preserving the status quo, could you give a definitive answer as to whether you would be better off having made the Federal Home Loan Bank Board choice or not?

OPTION OF LIQUIDATION OR MAKING A DEAL

Mr. **Bowsher**. I think we would be in a better position to answer that question when I believe we are coming back in March and would have had more time to look at the deals. But our preliminary thought is that if you look at the difference between the liquidation option and the deal option using FSLIC's numbers, why it is not very large. And then when you look and see how the calculations were made, the big thing I think will prove to be, although I don't have the answer for you today, is on the tax breaks.

Senator **Gramm**. I agree with you. I don't know the answer to that. The question I asked was, if you didn't have the liquidation option, were you better off to do what they did or preserve the status quo? That is another question altogether.

Mr. **Bowsher**. My advice would have been to stay in the status quo and to try to get as much control as you could over the institutions and waited for the Congress to put together the package of reforms and the money.

Senator **Gramm**. Well, let me ask you my last question, which is related to that, although I remind you, FSLIC has been waiting for the Congress now for some time. I see that I am in the situation like Senator Heinz was in, since the yellow light just came on.

I get the impression that people have this idea that there are still these savings and loans making these terrible loans, entering into all these crummy deals. In looking at FSLIC's operation, did you find that they were still allowing troubled thrifts to enter into these deals, or have they stopped that from happening?

Mr. **Bowsher**. There are some constraints, but there is also a lot of forbearance in these deals, and so they can possibly continue to do some of the things that got them in trouble, would be our answer today.

Senator **Gramm**. A final question. I looked up the numbers. We currently have a risk—an insurance premium for FDIC of 1/12 of 1 percent, and for FSLIC we have 1/12 of 1 percent plus the 1/8 of 1 percent, and that's of all domestic deposits. Given the liability of, the potential liability of, the taxpayer with full faith and credit, do you think that premium level is high enough?

Mr. **Bowsher**. I think it should be reviewed, Senator. In other words, I think with the way that the FDIC fund has come down, not so much when you look at the actual totals, but when you look at a percent of what it is covering and things like that, I think the premiums should be looked——

Senator **Gramm**. For all the institutions.

Mr. **Bowsher**. For all the institutions, and I think that, as you're aware, their percentage is in law, and so it would take a change in legislation.

Senator **Gramm**. Thank you, Mr. Chairman.

Mr. **Bowsher**. Mr. Chairman, could I—as long as Senator Gramm is here, I would just like to answer the opening statement a little bit, Senator, because you obviously are concerned, and I am sorry that you are. I would like to point out just two things. On this S&L crisis, the GAO has tried for 4 years to alert the Congress as to the magnitude of the problem. And although the problem has been growing, I think you will see our numbers all along were a little ahead of most other people as to what the size of this problem was.

Now that is exactly the reason that I issued some of those reports on the budget during the transition. In other words, if you look at the budget documents that were presented to the Carter administration in 1977, and to the Reagan administration in 1981, you will see why both Presidents came out and said it would not be difficult for them to balance the budget. Mr. Carter said, I think in his second or third year, and Mr. Reagan in his third or fourth year. And what I say is, we have systems there and reports coming out that do not indicate what the true financial picture is of the Federal Government, and I wanted this time around to make sure that the new administration and the new Congress were aware of all the problems. And when we close up the fiscal year 1988 books on September 30 and virtually have nothing in there for this thrift problem, for the nuclear weapons system problem, for the bow wave we have in defense, for the cost overruns that we have in the Government, I think we are kidding the people who are coming into office to assume power.

That was the motivation. It was not in any way trying to become more personal or whatever terms you use. We were trying to be of service in as objective and independent manner as we always have been.

Senator **Gramm**. Mr. Chairman, could I respond very briefly.

My basic response, Mr. Bowsher is, I think that doing that, presenting an analysis of the bow wave, presenting an analysis of the nuclear weapons cleanup, an analysis of the savings an loan problem, I think that is exactly what you ought to do. I think where you get into trouble is where you take really value judgments and convert those into findings. I mean, the clear reality is, and I just take one point on your study about the need to raise taxes; we can agree or disagree that taxes ought to be raised, but nowhere in any of your studies can you conclude from the evidence that they have to be.

Mr. **Bowsher**. We didn't say that they have to be.

Senator **Gramm**. Well, I will be glad to sit down with you afterward with those reports, and I appreciate your willingness to do that.

Mr. **Bowsher**. Yes, we would like to do that.

The **Chairman**. Very good. Senator Wirth.

Senator **Wirth**. Thank you very much, Mr. Chairman. I know that Senator Shelby touched on this, and the chairman has mentioned it before about the need for an S&L industry overall. You say on page 5 of your testimony, "There ought to be greater consistency between banks and thrifts," which seems to me you are beginning to raise the question whether we ought to have a separate industry.

Mr. **Bowsher**. Yes.

Senator **Wirth**. And you are coming back to us with this, it seems to me, has to be part of a set of recommendations we have to think about or options that we have to think about.

STUDY WHETHER WE NEED SEPARATE INDUSTRIES

Mr. **Bowsher**. I think the Congress should think about it, and they should analyze it. And if we can be helpful, we would like to do so, because there is no question here now that the S&L industry, as we know it, and as we have created really a new group, are doing a lot of lending other than home mortgages, which is what it was originally set up for.

Senator **Wirth**. Mr. Chairman, I don't know if we might just ask GAO to very specifically come back to us in answer to that question: Should there be a separate regulatory authority and a separate industry among the S&L's who are doing a lot of other things as far as I can, that normal commercial banks are doing and that other financial institutions are doing, and does there remain a major rationale for this industry anyway? I don't know, but it seems to me that that is a question we ought to get your best judgment on, having looked at this.

Mr. **Bowsher**. One think we might want to do, and I just throw this out as an idea, is to do that study after you've done the reform on this—the legislation on this, unless you try to tackle the whole thing at one time, including the banking and S&L industries. Then we would try to do it ahead of that.

The CHAIRMAN. Well, I would like our action to be as comprehensive as we can make it. That means addressing not only the restructuring, but also what should the industry look like in the future. My mind is open on that question. I will talk to the Senator from Colorado. It is partly an issue as to whether CAO is best or even well-equipped to analyze the S&L's housing function in relation to the rest of the powers granted by Federal statute and also, the additional powers that different States have provided, State by State. That is a very, very complex policy issue. It has to be looked at. Let me just ask you, Mr. Bowsher, does that question move out quite far from the kinds of studies that typically fall within your range of activity, or would it be something that you feel you could do in a timely manner?

Mr. BOWSHER. Well, I think it would be a difficult study, needless to say, but it is the kind of studies that we do do and are asked to do by the Congress. So if the committee would want us to do it, what we would like to do is come over and meet with your staff and tell you what we could do, how we could do it, and in what time frame and things like that.

The CHAIRMAN. I heard a very important related point, in a meeting yesterday. A top administration official indicated that their best estimate of the percentage of home mortgages originated by the savings and loan industry presently was on the order of 25 percent. I think I heard you today use the figure of 50 percent.

Mr. BOWSHER. Yes.

The CHAIRMAN. And there is a big difference between 25 percent and 50 percent. I think, at a minimum, we ought to reconcile them.

Mr. BOWSHER. We could sort that out, I am sure. Thrifts originate almost 50 percent of new mortgages. However, many of these mortgages are then sold in the secondary markets. The actual share of total mortgage debt outstanding that is held by thrifts is just over 25 percent.

The CHAIRMAN. Let's take that under advisement. That may very well be a very constructive suggestion.

Senator WIRTH. Mr. Chairman, as long as we are looking at this, I just saw that softball in the middle of page 5, which caused me to ask, you know, what you meant by getting greater consistency, and it seems to me that that suggests that, you know, you may be thinking about the fact that these are functions that are becoming very similar. My mind isn't made up. I don't know, Mr. Chairman. I don't have any idea, but it seems to me that is the kind of question that we ought to be asking before, you know, we conclude that what we want to do is to nibble around the edges with a number of reforms, maybe, you know, we say, OK, let's just bite it all the way.

Mr. BOWSHER. The one caution, I would say, is that we think that the S&L crisis and the urgency here is significant maybe two bites has some merit too.

Senator WIRTH. I understand. But I just think if we could work out a way in which we might start on that process so we can think about it.

Mr. BOWSHER. And we really do believe that the consistency is needed there, because what you really need is a safe and sound banking system. If you need two systems, you know, that may be all right, but a safer and sound system is where we all have to get to.

FRAUD AND INSIDER ABUSE

Senator **Wirth**. While Mr. Wolf is here—I know he is not going to be here next week, and next week we are going to be talking about fraud and insider abuse, but I know, Mr Wolf, that you spend a lot of time on this issue, and I was wondering if you might have, following up on the general statements that Mr. Bowsher made, if you might be able to comment on how pervasive you-all have found the fraud and insider abuse to have been in the failed institutions.

Mr. **Wolf**. We did a review in particular of about 26 failed S&L's, some fairly good size, some not, and either fraud or inside abuse was an issue in every one of them.

Senator **Wirth**. Did you review those—how many institutions did you review?

Mr. **Wolf**. 26.

Senator **Wirth**. Were those at random, or were these egregious problems?

Mr. **Wolf**. They were selected from the list of insolvent S&L's that were dealt with sometime in 1985 to 1987. It was not a completely random selection, so I don't want to say it exists in every case. I believe Danny Wall said that fraud caused 20 percent and was present in 70 percent. To my knowledge, he was including insider abuse, which is also a significant problem. So I think both groups have come up with the fact that it is a significant issue.

Senator **Wirth**. And have you concluded that fraud played a significant role in the failure of those institutions?

Mr. **Wolf**. Well, I guess I would include fraud, insider abuse and sort of reckless lending practices as a collection of three things and clearly, those three were a significant cause in many of the failed institutions.

Senator **Wirth**. You have done a lot of work on this. We are going to hear from the Justice Department, I think it is, Mr. Chairman, next week, the fraud issue. Are we getting from you a sort of a summary of the study you have done or a compendium of that, or is there a——

Mr. **Wolf**. We can make that available to you. We testified in front of the House Banking Committee in San Francisco about 2 weeks ago, and I can make that available to you. It covers all of those issues.

Senator **Wirth**. Are there other comments that you might like to make at this point on the record about the extent of fraud and insider abuse?

Mr. **Wolf**. No, but what it points out to us is that the examination, supervision, and the auditing function clearly needs to be strengthened, so that it gets ferreted out at the front end, so that it doesn't create some of these problems. It is just one of the reform elements, but it is clearly one that needs some attention.

Senator **Wirth**. Thank you, Mr. Chairman. I had another question about assets and what we do in fragile economies like ours, Texas, and so on with the assets that are currently owned, but if we come around to another round, I will ask those.

The CHAIRMAN. We are coming around to another round. Senator Kassebaum.

Senator KASSEBAUM. Thank you, Mr. Chairman. Mr. Bowsher, I would like to continue just one moment with part of what Senator Gramm raised on considering whether it would have been better to merge or liquidate. It is my understanding that FSLIC does not consider tax subsidies when they make an analysis of whether it is more cost effective to merge or liquidate and that they are prevented from doing this by statute.

Mr. BOWSHER. That is correct. In other words, the statute tells them how to make the calculation and excludes that. But I think truly when the Congress now is looking at the done deals, you might say, and considering whether they want more of that in the future or they want to consider more taking control and liquidating these really bad situations, our recommendation is that the tax benefits be included in the calculation.

Senator KASSEBAUM. Well, it would seem to me it would be a significant cost at some point.

Mr. BOWSHER. It might prove to be very significant.

Senator KASSEBAUM. Continuing on, on the megadeals with or Southwest plan type of deal, there were experts who testified here yesterday in the thrift industry, and Mr. Bryan, the one, expressed grave concerns about the megadeals, felt they were competitively unhealthy and inequitable for the marginal and healthy thrifts, and in the long run would be of greater cost, and you expressed some of these same concerns.

Mr. BOWSHER. That's correct.

Senator KASSEBAUM. I am wondering if you think we should suspend immediately any further megadeals until we, indeed, act here.

TEMPORARILY SUSPEND DEALS

Mr. BOWSHER. One of the things that I think the committee should consider is some kind of a cap. We recommended it last year, and as was pointed out here, the Senate did pass it, but it was not passed in the House, and therefore, no cap was put in place. But I truly believe it is better to sort out the program, get the reforms in legislation that you believe are necessary and wise, and then, and only then, commit the American taxpayer. And so we would recommend not going forward with a lot more of these megadeals.

Senator KASSEBAUM. So suspend immediately.

Mr. BOWSHER. Yes. I would give some flexibility, because I think you always have some unique situations as you are trying to monitor 350 institutions. But I think what you really have got to make a tough decision on, is do you want more of these? Or do you want a different program, literally, that has the reforms built into them before, as I say, you commit the American taxpayer, because it is going to be very, very costly over the next 7 to 10 years just for the ones that have been done. And you truly have created a new savings and loan institution base here that have competitive advantages over other S&L's and over banks.

If you just think about it, if there is a bank, say, in Texas or California down the street from one of these, they don't have their assets returned up to full value They don't have guaranteed profits and service charges as they liquidate problem assets. And so they are trying to get the same deposits, the same business, let's say, from the community as an institution that we now really have not only nationalized, but really put the power of the Treasury behind, in some form or another as the money becomes available. That is not an equal ballgame.

Senator **Kassebaum**. I certainly agree, and it seems to me that if we would suspend, effective immediately, it puts a lot of pressure on us to really try and move forward, both the administration and the legislative branch, but also, of course, it would seem to me, if that is done, we've got to have money on hand with which we can step forward and liquidate those that need to be closed immediately as well. And that, of course, goes right back to, I think, the opening question of yours, Mr. Chairman. And with that, I guess I'll close unless you—you said you didn't have an answer to that either.

The **Chairman**. Well, if you would yield on my time just very briefly because Senator Sarbanes has been waiting a long time.

Senator **Kassebaum**. That is the only question I have left.

The **Chairman**. Your suggestion has a lot of wisdom in it. However, as a matter of fact, even if we were to reach that judgment as a committee, completely, and were to reflect that view to the Federal Home Loan Bank Board, the Treasury Department, representing the President, would also have to come to a similar view. In addition, the officials at the Federal Home Loan Bank Board wouldn't necessarily be bound to act on your suggestion, because they have a duty to act according to their operational charter as they understand it. Obviously, your suggestion would constitute a strong recommendation if it were made by everybody together. I spoke to the Treasury Secretary before the end of the year as this series of transactions was unfolding, to express my concern about the situation. That is when we requested this audit in which you are now wading through the documents to find out exactly what happened.

For my part, I would hope, unless some extraordinary situation develops, that we could not see a burst of activity until we have had a chance to act, particularly in light of the fact that we are moving rapidly. There is a meeting scheduled tomorrow at 8 o'clock in the morning with the President to discuss these issues. I would hope that the Federal Home Loan Bank Board will be sensitive to the fact that we want a more encompassing answer before we get locked into deals whose cost the General Accounting Office today can't estimate.

Senator **Kassebaum**. But the Comptroller General did say that there are deals coming up in the next coming week.

Mr. **Bowsher**. We know that there are more deals being negotiated, that is right.

The **Chairman**. That is something that the committee ought to reach a judgment on together. Senator Sarbanes.

Senator **Sarbanes**. Thank you, Mr. Chairman.

Mr. Comptroller General, I want to commend you and your colleagues for, I think, an excellent presentation and a very fine report. I want to thank Chairman Riegle for moving so quickly in this matter. I mean, it was literally days after he was, in effect, nominated to be the chairman-elect of this committee, even before he was formally the chairman, that he moved to ask you to undertake this study, and I think your testimony here has been very valuable, and I am very frank to say that I hope we will continue to draw on you in a consulting role to the committee as we carry through the reset of these hearings that we have looking at this issue. You obviously have moved in and gotten a grasp of the situation, although as you yourself point out, there is much that you yet need to know.

ADDITIONAL RISKS ON END-OF-YEAR DEALS

Do you have any breakdown on the additional risks that were assumed by these end-of-the-year deals? As you pointed out, one of the problems is that they have now put the Federal Government on the hook not just for covering depositors on the basis of the deposit insurance but now extending guarantees to those through these merger arrangements or other aspects of the deal took over the responsibilities, and do you have a breakdown between the two? Any sort of breakdown.

Mr. **Bowsher**. We don't really have any more of a breakdown than what we have presented here today, Senator. But as we move through and study them more and when we come back, I think we will have a further breakdown.

Senator **Sarbanes**. When you say that you presented here today, what are those figures?

Mr. **Bowsher**. Well, we do have a breakdown of how much we think over the next 10 years it is going to cost the FSLIC to resolve the deals that were made through the end of 1988—and that is $60 billion—to resolve the deals that were made in 1988. And we pointed out that FSLIC estimates over the next 10 years it is going to have available, based on the special assessments, the recapitalization program, and all the interest that is coming in, only $34 billion. So FSLIC is going to be short around $26 billion.

Senator **Sarbanes**. Well, my question is, of the $60 billion to resolve the deals already made, how much of that $60 billion is simply to cover the deposit insurance and how much of it may well be involved to cover the other guarantees that were extended as part of making the deal?

Mr. **Bowsher**. I think Mr. Wolf can give you some breakdown on this.

Mr. **Wolf**. We have got some information, and it is only on the Southwest deals, but to put that into perspective, of the $60 billion, roughly $44 billion is for Southwest plan deals. Of that $44 billion, $9 billion is notes, $8 billion is interest, $15 billion is capital loss coverage, $11 billion of it is guaranteed future income. There may be some minor adjustments to those numbers.

Senator **Sarbanes**. How much of it is for the deposits?

Mr. **Wolf**. Well, this is, in effect, a substitute for paying the depositors. Instead of paying off the depositors, what we did is, we sold the institution.

Senator **Sarbanes**. What would it have cost to pay off the depositors?

Mr. **Wolf**. I don't have the exact number.

Senator **Sarbanes**. Well, that is the number I want.

If you can get that to us. I mean, suppose they had done these deals, and we said, all right, we are just going to pay the depositors, everybody else takes a bath. That's part of this enterprise system and particularly for these people who have been, you know, really running wild, and so we'll pay the depositors. They were guaranteed. We are going to meet that guarantee, but we are not going to do any more. That's it. How much would that have cost? And I want to compare that with what this approach would cost.

Mr. **Wolf**. The institutions closed in 1988 held about $115 billion in deposits. So, it would have cost about $115 billion to simply pay cash to the depositors. The estimated liquidation cost for these same institutions is about $47 billion. This $47 billion of course, is a net present value estimate, and takes into account recoveries on assets that are sold in the course of the liquidation of the institutions.

Senator **Heinz**. A point of clarification.

Yes. Is the 44, as you laid it out, is that on the present value basis or not?

Mr. **Wolf**. No. The $44 billion is for Southwest plan deals and is on a cash basis. In other words, that is the amount of checks the Federal Government will write.

Mr. **Bowsher**. That's our best estimate at this time.

Senator **Heinz**. Just let this be on my time, not on Senator Sarbanes' time. But the checks that will be written out to make $44 billion would not, as in a cash payoff to the depositors this year, they will not be written out this year. They will be written out over a 10- or longer year period

Mr. **Bowsher**. That is correct.

Senator **Heinz**. All right.

You compared apples and oranges. Cash 10 years from now is not the same as cash today.

Mr. **Wolf**. If you consider the present value, the numbers are relatively close, but then you get to the problems that Mr. Bowsher was talking about. Tax loss is not in the calculation, and they used a higher interest rate to discount, which means the present value goes down.

Senator **Heinz**. I understand.

Senator **Sarbanes**. Do you have the tax loss.

The **Chairman**. Just one minute. I would like the Clerk to reinstate Senator Sarbanes' time.

Senator **Sarbanes**. Do you have a tax loss figure too? Can you give that to us in a report?

Mr. **Wolf**. Our estimate of the tax benefits for the 1988 transactions is between $7 billion and $8 billion in present value terms.

Senator **Sarbanes**. The other line of questioning I wanted to pursue is to what extent the good institutions are being dragged down by this situation? Now as I understand, one of your reasons for the approach you are suggesting is that the shaky institutions, and one—first of all, is the unfair competition on the interest that they are offering, in order to attract deposits, applied to the deal making—the institutions to which deals are made as well as to the institutions whose difficult situation has not yet been addressed?

Mr. **Bowsher**. Yes. To both. In other words, I believe it is the Federal Home Loan Bank Board's position that they will not have to pay as much premium for their deposits on the deals that have been made, because they feel now that they have brought in new management. They have brought in some new capital, and they will not be in as desperate a shape, let's say, for deposits, and therefore, will not have to bid them up. But that's yet to be seen, just what differences you will get there. Then, of course, on the 350 that are still left, they are still many of them very desperate for their deposits and are having to pay a premium to get those deposits.

Now I think the other problem that the healthy thrifts are concerned about is that when you did the deals and you put this group into being, you are not getting them out of there in 2 or 3 years. The chances are, it could go a number of years. The contractual arrangement for most of them is up to 10 years. In their calculations, they use 7½ years, I think, in most cases, but what that means is that the healthy thrifts have some real competition in the future for those deposits.

DANGER OF DRAGGING DOWN HEALTHY INSTITUTIONS

Senator **Sarbanes**. How much danger is there that the healthy, good institutions are going to be dragged down by all of this?

Mr. **Bowsher**. I think they feel they are going to be dragged down, but I am not sure we could quantify it.

Mr. **Fogel**. We can't quantify that, Senator. We do know that healthy thrifts still have to pay the special premium to FSLIC. One of the things we are saying is even in a reform approach, you'd still want the healthy thrifts to pay some additional premium to capitalize the new healthy fund. But one of the difficult areas that we haven't been able to quantify is exactly what would happen to them.

Senator **Sarbanes**. Well, that leads me into my next question, and that is, is your final report going to look at this S&L-to-bank relationship and the FSLIC-to-FDIC relationship——

Mr. **Fogel**. Yes.

Senator **Sarbanes**. The broader question that Senator Wirth and some others have put in this morning.

Mr. **Fogel**. Yes, it is.

Senator **Sarbanes**. You've talked about a two-step response, I think, but you know one also ought to examine whether, you know, just the one-step thing to regularize this thing to the extent one can see it once or for all ought not to be looked at as well.

Mr. **Bowsher**. If you remember last year, the committee was looking at the whole Glass-Steagall issue and really restructuring the financial institutions of this country. Our report will not look at that issue as it now is constituted, nor at the issue of whether you need the separate thrift industry. What it does do is try to give recommendations as how it should be structured and how the reforms ought to be in place pretty much on the assumption that you would have a separate S&L industry made up of the healthy institutions. But it does get to the restructuring of FSLIC and some of the features of FDIC.

Mr. FOGEL. It does recommend a conversion of powers for both the S&L industry and the banks, so it gets at it. But, quite frankly, one of our concerns has been that if you open up everything, you may never be able to get legislation through that deals with this issue. What we try to lay out is a series of reforms that we think are absolutely essential to deal with the S&L crisis that allows you then, over time, for example, to address in more detail the issue of whether you need a separate S&L industry.

Senator SARBANES. Well, but it seems to me that if you can do it, you ought to add that broader dimension, so you have some sense of whether you are making these changes in a context which it is judged it is not a sustainable or desirable context over the longer run.

Mr. BOWSHER. I see the wisdom of your suggestion, Senator, and what I would like to do is go back, I think to what the chairman was suggesting that you people consult. Maybe we can do that as a separate report, because I think we are very close to being able to issue this report and give you the recommendations and our facts on this set of issues. We can understand why you might well want to be looking at the bigger issue.

Mr. FOGEL. We will try to make sure that this is done in the context of that broader framework that ought to be considered.

Senator SARBANES. Well, Mr. Chairman, I think this is something that maybe we can explore with the Comptroller General and see whether it helped.

Could I just put one final question? I know my time is up.

The CHAIRMAN. I am sure Senator Heinz will respond with the same graciousness that you earlier showed to him.

Senator HEINZ. I would be delighted.

Senator SARBANES. Does your report include or will it include a geographical breakdown of the problem? Have you identified the problem, geographically?

Mr. FOGEL. We have that in our schedules, and we could include that, yes.

Senator SARBANES. Did it relate to the laxity of the laws under which—I mean, I have this impression. I just want to get some sense of whether it is on the mark or not. There were a number of State-chartered institutions that were able to avail themselves of Federal insurance. They were not subjected to the same restraints on their powers and operations that a federally chartered institution would have been in the S&L system, and that this provided the opening for a wide range of practices that have led now to this fraud, insider abuse and reckless lending practices that were identified by Mr. Wolf as being at the heart of much of what has occurred.

Is that perception close to the facts?

Mr. BOWSHER. It is part of the problem. In other words, the Congress here gave enhanced powers to the industry in the early 1980's with your legislation. Some of the States then took it further with some of their legislation. At the same time, the supervision, the regulation, the auditing, was pulled back—sometimes just because the industry grew—and you didn't have any growth in the capability of regulation. Therefore, you had in many respects some new institutions out there that didn't look much like an S&L, and they went into areas that were not traditional S&L avenues of investment, and many of them didn't work out. This is in areas where you had deep regional economic problems, such as the Southwest, but also in some areas like California where you had strong economies.

Mr. FOGEL. And one of the recommendations we make is that FSLIC have the authority not to grant Federal insurance to institutions, unless they adhere to what we think the appropriate Federal regulations ought to be.

Senator SARBANES. OK. Mr. Chairman, I was not here at the time that the committee—because I had to be elsewhere—took its vote on Mr. Boskin to chair the Council of Economic Advisers and Congressman Kemp to be the Secretary of Housing and Urban Development. I would be recorded in support of those nominations.

The CHAIRMAN. You will be so recorded. Thank you.

Let me just announce that Mr. Steven Ledbetter who is in the room from the Treasury Department has a call that he needs to take and return, if he would come on back here and do so. Senator Heinz.

Senator HEINZ. Mr. Chairman, just one thing that is a little unclear and maybe the GAO can come back to us on it, on the subject Senator Sarbanes was discussing which I interrupted.

In table 5–B of the letter of January 9 from Danny Wall to Henry Gonzales, there is an analysis of the costs of all the deals made by the Federal Home Loan Bank Board in December. That analysis claims that their resolution cost was roughly $19.5 billion versus an estimated cost of liquidation of $22.8 billion. Therefore, the resolution that they proposed saves $3.3 billion. I am not looking for an instant answer, but we would appreciate your analysis of whether or not these estimates are sound and to the extent you disagree with them, why.

Mr. BOWSHER. Yes. That is what we are doing. We are selecting a number of these off this list, and we are doing the analysis, and that is what we have been asked to do, yes.

Senator HEINZ. Very well. Let me ask you about your fundamental recommendation, which is for the Government to step in, and as it was reported on the front page of the business section here, and seize 350 troubled S&L's. On page 2 of your testimony, you state that delay in doing so is going to perpetuate the tendency of weakly capitalized institutions to squander our Nation's wealth on questionable economic endeavors at no significant risk to their owners.

The reason I would like you to elaborate on that point is this. It is my understanding that in 1985, the Board issued a regulation that explicitly limited growth of thrifts with low capital. That limit was strengthened in October 1985 and then again in 1988, so that insolvent institutions are now prohibited from making new loans or investments, unless their supervisor specifically approves that. The regulations also prohibit undercapitalized thrifts from growing in excess of "interest credited" without permission of their supervisor. I have been advised that these policies have been very effective, and the annual growth of these thrifts has dropped from 19 percent in 1984 to 5.8 percent in 1988.

Now with respect to equity investments, the Board has taken similar action. Beginning in 1985, the Board has issued direct investment restrictions which, as I understand it, have limited undercapitalized thrift investments in real estate, equity securities and similar investments. Thrifts failing their minimum capital requirements may not make such investments without the express permission from their regulators and high capital requirements must support these investments.

Now in light of these regulatory efforts, it is my understanding further that insolvent or near insolvent institutions, these are the 350, I think, that you have identified, are essentially limited to investments in either cash or Government securities or mortgages and similar prudent investments.

ARE NEW REGULATIONS WORKING?

Now do you agree that these regulations have been effective and, if not, could you provide examples of how poorly capitalized thrift institutions have continued to make risky investments since these regulations went fully into effect?

Mr. Bowsher. First, let's say that putting those regulations in place has been helpful. In other words, since the regulations have been in effect, there is no question that some of the growth of these insolvent institutions has reached a plateau. Now at the same time, you have to go out and monitor that. One of the problems is that, we have seen some situations where, the owners, old management, have sometimes not abided by some of the directions and some of the guidance that they have gotten. I think there was a story about one of those in California on NBC the other night. A real estate developer bought an S&L. However, he hid the fact that he was a developer from the regulators. All of a sudden the fund has to spend half a billion dollars to resolve the S&L. Now that guy is going to jail. Another problem is that irrespective of restrictions on certain categories of assets, insolvent thrifts will continue to seek the highest return they can, thereby placing the fund at greater risk.

Senator Heinz. Did those practices take place since the last lock was put on the door in 1988?

Mr. Bowsher. We would have to go back. Fred, would you know about the last one.

Mr. Wolf. Yes. I'm not sure about that.

Senator Heinz. By the term "lock put on the door" I mean—the limit on growth that was strengthened in 1988.

Mr. Wolf. They have done things to strengthen or to limit what people can do and put some controls on there.

Senator Heinz. This is Bank Board Memorandum SP-66 in Regulatory Bulletin 3-A.

Mr. Wolf. I guess in a sense, moving in the right direction. Whether they've gone as far as they need to be, I don't know.

Senator HEINZ. I am asking a very specific question. Since those went into effect, do we know of a specific example of an imprudent investment being made by one of these 350 S&L's? There may very well be, but it is a very material question for this reason. If imprudent practices are continuing, whether due to an inability to supervise or inadequate regulations, then your case that we should move instantly, urgently, is strong. If, on the other hand, you cannot supply evidence, the case for Congress rushing forward and maybe doing a partial job, as some people want to do, is, in fact, a very different case.

Mr. BOWSHER. Yes. We do not recommend the partial job.

Senator HEINZ. I understand that. I am not asking you whether you recommend a partial job or not. I am asking whether you have evidence that the problems that we all know got us into this mess have, as a result of regulatory actions that have been taken, got the mess under control. If, in fact, it has, then there is a much less persuasive case for prompt seizure—that is the press' word not your word.

Mr. BOWSHER. That is correct.

Senator HEINZ. I'm referring to seizure of the 350 insolvent S&L's.

Mr. BOWSHER. Yes.

Senator HEINZ. But if you have proof, it is a very strong case for much more being done much more quickly. I am just asking, as people who are very good at providing proof and evidence, what is your evidence?

Mr. BOWSHER. Yes. Let me point this out, Senator. We do not audit the individual S&L's. We audit the FSLIC fund, and then we do special reviews when we are either told there is a problem or we are asked to do it. Most of our revenues go back before the 1988 circular was put out. I think your question is an excellent one; it should be asked of Mr. Wall. But the losses that are piling up out there also occur when insolvent thrifts are paying more for their deposits than what they earn on their assets.

Senator HEINZ. Let's assume that tomorrow, because we enacted today the legislation that you say we need, the Government goes out and we fill those thrifts with FDIC personnel, so that they are really run under a tight government trusteeship, would it not be the case that those S&L's would still be paying more for their deposits than they are receiving? Nothing we can do is going to change that, is there? We can only keep people from making bad decisions.

Mr. BOWSHER. Yes. In fact that is precisely what the FDIC has been doing. They deal with 100–200 institutions a year by taking control of the institution and then liquidating, if necessary in a fairly expeditious manner. That is what we are really recommending. The actual liquidation, of course, takes several months to several years to complete. So the main point is to really get on top of the individual entities out there and determine the extent of the losses, but not take as long as 7½ or 10 years to work it out. You don't do it overnight. You don't do it in 1 year. That is why the word "seize" is unfortunate, but you've got to get on top of the situation, and you have to do it institution by institution.

Mr. **Fogel**. Senator, one of the issues that has us concerned is the sudden flurry of deals that were made in the latter part of 1988. We don't think that FSLIC really knew, as extensively as they should have, the conditions of some of these institutions when they made these deals. We don't want to have more of these types of transactions—where you go in very quickly, without knowing very much about the value of the assets in the institutions, yet you fashion deals that obligate the Government for 7 to 10 years. That is why we say you have to examine each institution closely, determine the extent of the losses, then figure out what it is going to cost you. Then you can begin a workout.

Senator **Heinz**. There is one more question I would like to ask.

The **Chairman**. We are trying to be accommodating at this hour of the morning, and these folks have been very patient.

Senator **Heinz**. How about this hour of the afternoon?

The **Chairman**. Why don't you go ahead.

Senator **Heinz**. I will just ask one here. On Tuesday, when we had Mr. Bryan from McKinsey and Co. and other witnesses before us, one of the questions that was asked which elicited some disagreement from Mr. Horvitz of the Federal Home Loan Bank of Dallas, in particular, to which Mr. Bryan answered in the affirmative, was then when you have an insolvent institution, one of these 350, is the best policy always to step in and liquidate it?

Mr. **Bowsher**. No. In other words, not always, you have to go in and determine the value of the assets, and decide, what is the best alternative. You have to consider the current real estate market and everything like that. Everything considered, you might well want to do something other than liquidation, but we think that many of the 350 probably would be liquidated, if you were trying to achieve the lowest cost to the taxpayer.

Mr. **Fogel**. But the key is to really focus on the institution and make an individual decision based on fairly detailed knowledge of the condition of that institution, and that is not really what was going on in the latter part of 1988.

Senator **Heinz**. Mr. Chairman, I appreciate your forbearance. Of course, that's what got us into this trouble in the first place. [Laughter.]

The **Chairman**. I want to commend Senator Heinz and the other members who have been here this morning and have been asking such good questions. I think the key to laying this problem out and deciding how to resolve it is precisely the kind of care and time that Senator Heinz is taking, and Senator Wirth, and all the others that have been participating this morning.

LAST MINUTE DECEMBER DEALS

I think you have given extremely important testimony here today which will have a great impact.

I want to now pursue two or three things. I am particularly struck by the observation made by Senator Kassebaum that wittingly or unwittingly, the Bank Board's burst of deals in December has created a new class of savings and loans, that has complete advantage over others. The full costs of the deals to the Government and the taxpayer aren't totally known, partly because the tax losses were not really put into the calculation. And I am very troubled about that. I understand the argument of the Federal Home Loan Bank Board that that is the best they could do, and so they moved ahead. But I have to juxtapose what Mr. Fogel has just said with the stories about the hectic way in which the Bank Board was doing these deals, at all hours of the day and night, as the year-end cutoff approached. The stories say that there wasn't even time to clear the documents out of the room, that they were going through these sets of documents saying yes or no, working out the deals, and were piling the documents on the floor, as they dealt with them.

We are committing tens of billions of dollars, maybe something on the order of $38 billion, if you use a discounted cash flow, out over the next 10 years. We're not sure even that that captures the whole cost. In actual dollars the Treasury may have to write checks for at least $60 million over that period of time. And that deals with only part of the S&L problem.

So we have to go back and find out exactly what took place here. You are doing that work and in due course I want it all out into the light of day.

I also want a very careful understanding of whether competition to take part in the deals was fair and proper. I question whether there were some people who wanted to get into the bidding process but couldn't. Others were included, and I don't understand how the distinctions between the included and the excluded were made, but it is obvious from what you have said here that these were very good deals for the people who did get into them.

Is that a fair summary?

Mr. BOWSHER. We think so. I would like to withhold final comment on that, but there is no question—some of these people have come to us already to meet with us. I can tell you that they were well-staffed with legal talent, tax accountants and all the advisers they needed to work out these deals.

The CHAIRMAN. The acquiring groups——

Mr. BOWSHER. The acquiring groups.

The CHAIRMAN. The people who got in on this just before the——

Mr. BOWSHER. And when we asked some questions, like on the tax benefits, we got some education on what some of their thinking was. The deals were obviously put together in a great hurry, and I'm not sure the Government side was properly staffed or represented. I don't have any detailed facts at this point, but that is my impression just from what we are hearing from the people who are the deal makers.

The CHAIRMAN. Is it your provisional impression, while you are still wading through the data, on the basis of the general facts that we know, that the value of the tax losses in some of these deals were so great in relation to the modest amount of capital put in, that the people recovered their capital in just a matter of a very few months?

Mr. BOWSHER. We're not sure, but we think there is that kind of potential in some of these deals, and that is why in my early summary I said it might be more the IRS that is the capital contributor than the private sector.

The CHAIRMAN. Well, of course, the IRS means money from the taxpayer—you and me and everybody in the room and outside the room.

Mr. BOWSHER. These tax benefits have implications over the next several years. In other words, similar to the guarantees, we don't know even at the end of the first year how much tax benefit has been built in there, and the acquirers will have a lot of talent working for them trying to figure out how to get the most out of the tax arrangements that were built into the deals.

The CHAIRMAN. I have a series of additional questions I want to raise, but I want to call on Senator Wirth now, and then I will go to my remaining questions.

Senator WIRTH. Thank you, Mr. Chairman. Just on the heavily staffed out with experts, it seems to me that, you know, if you were out there as one of these acquiring groups, you know, I think, and I have said that to these people, I would get in line too. I mean, if you are having this huge pot of gold that is being handed out by Danny Wall and company, you would get in line and get your attorneys and accountants and see how much you can get. I really don't fault these guys. You know, they're pretty smart operators.

Mr. BOWSHER. Oh, I think they saw an opportunity and they moved right in there.

Senator WIRTH. And on the fair and proper bidding, we had asked you that last fall. And I know you are undertaking a study that Senator Riegle and Senator Sasser and I asked you to do, to be looking at, you know, the question as to who got in, who got considered, how were they considered. That is coming back to us, I understand, in March; is that right?

Mr. BOWSHER. That's right. Mid-March.

Senator WIRTH. That's good. Third, on the IRS as contributor, it is my understanding that Larry White, one of the Board members, had written a memo to the Board on December 20, and that in that memo, he suggested that he was concerned about how the Bank Board had been costing out a liquidation versus assisted acquisition with respect to foregone and suggested on December 20, that the Board ought to devise a way to more accurately reflect the cost of the tax benefits to the Treasury.

Now if this is the case, all right, that he was writing his memo on December 20, you know, the fire drill is underway, all this is going on, and suddenly the Bank Board says, "Hey, wait a minute. We ought to be more accurately looking at the cost of this to the Treasury."

Have you seen that memo, do you know?

Mr. FOGEL. We have been provided a copy of that memo. I haven't personally read it, but we do have a copy of the memo, yes. And it certainly indicates from their standpoint, as we said earlier, they did not take into account tax consequences when deciding whether on these deals, a merger or liquidation was the way to go.

Senator WIRTH. That is pretty astonishing, Mr. Chairman, if this is happening 10 days before the first of the year, and all this stuff is being shoveled and the Bank Board, one of the members of the Board, is saying, "Hey, we ought to figure out a way to more accurately determine how much the taxpayers are paying for all of this."

Mr. FOGEL. Well, that's one of the problems. FSLIC only looked at these deals from the cost to them not the cost to the taxpayers.

The CHAIRMAN. If you would yield at that point, the way I have conceptualized that is who's guarding the cash door of the Federal Government, as these deals commit large sums of money in the future through tax losses? Who is really responsible today to blow the whistle, if it's imprudent. And we're right back to your question. I don't know yet that we have a good answer to it.

Senator WIRTH. You know, I don't know of anybody else in the history of the Republic who has had the authority that Danny Wall and company had to commit the taxpayers without any specific authorization from the Treasury to tens of billions of dollars. And even Weinberger at the height of the defense spendout, I don't think was capable of doing that.

Mr. BOWSHER. He wasn't.

Senator WIRTH. So you do agree with that statement?

Mr. BOWSHER. I agree with that statement absolutely, and if I could just build on it here. One paragraph in our report we really haven't discussed today is one on page 8; it says "Assure adequate controls over spending to protect the taxpayer interest, such as by creating a control board."

If you think back to the Chrysler case and some of these others, we put in place a control board that had to approve actions by the entities that were being helped. And that is one of the things that ought to be considered in the reform package here—control over the bad company feature or part of the restructuring of FSLIC.

Senator WIRTH. Now I've asked Danny Wall about a lot of us. We have talked on the telephone, and he says, "Look, I have the authority to do," which he did. I think it was pretty clear that he had the authority to do it, and he said we had to act quickly because things were hemorrhaging so rapidly. But I think it still raises, you know, questions to make sure that we don't repeat the mistakes of history, that we put a lot of checks in here. You know, we're already out tens of billions of dollars, pretty clearly, and I think that looking of the question of how they costed this out and where the authority is and what kind of checks on them will have to be part of this package. And I think that certainly is the thrust of a lot of the hearing to find out what we did before, so that we don't repeat the mistake in the future.

If I might, Mr. Chairman, let me ask another question that really is focused on——

The CHAIRMAN. Before you do, and I want you to proceed, I should add one item to that line of discussion. I was given a study that Mr. White on the Board carried out. He tried, as best he could, to make a calculation that factored in the tax benefits. I will send this down to you. Mr. White felt, after factoring in the tax losses, that most of the deals were still cheaper. There were some, however, where the mathematics indicate that this was not the case. Now I don't know that the calculations are right. But I want to balance the record. But please go ahead with your next question.

Senator WIRTH. The final question I have, Mr. Bowsher, is one that really troubles me a lot, coming from a State where we have a very fragile economy and a region of the country where the economy is still pretty fragile, in which the assets that are in, say, Silverado and Columbia, the two big S&L's in Denver that Ford has taken over. There are so many foreclosed properties. The Federal Government has taken so much back, it is now, I understand, owned by FADA. We are now trying to determine one, how to get rid of all these properties. And if the Federal Government dumps them onto the marketplace, what that does is further undermine the value of the real estate, and that further weakens the economy, which, if a lot of these deals are as fragile as you suggest, might endanger these deals as well, and the cycle continues downward.

So that is one set of concerns, and another is, if we proceed as suggested, on the other 350, and we follow a procedure of liquidation, what happens to all the properties that are then owned by the institutions that are liquidated? And what impact might that have on the economy, and what impact, in turn, would that have on not only the other sick institutions or those with a cold, but the healthy ones.

EXCESS PROPERTIES

Mr. BOWSHER. A very good question, Senator, and that is why you really need experienced, talented people out there handling these workout situations. You have to be careful that you don't damage the local economy, and every local economy situation is different. So you have to understand it. And that is why sometimes it takes longer to resolve cases in some areas than it does in others, and you have to make those kind of judgments. That is what the FDIC has been doing here, not creating a FADA, as the Federal Home Loan Bank Board did, but actually working these out, and you have to do it area by area, something like that, and you can't immediatly liquidate. In other words, when we talk about liquidation in our report here, we are not saying that you just do it automatically. What you do is, you take control. As Dick said, you look at those loans. You see whether liquidation is right or whether merger is better. You try to work it out, but you have to be very careful and very sensitive to the local economy.

Mr. FOGEL. I was going to say, even if the Congress acts now, it is going to take 3 to 5 years maybe to work through all of these institutions.

Senator WIRTH. It seems to me as we are looking legislatively, you can't, obviously, exercise good judgment, or you can't legislate good judgment or expertise or whatever, but there may well be ways in which we can write into whatever chances we have that this has got to be considered. You know, you have a local economic impact or whatever. You could be in a situation in a lot of these troubled energy States, where we could really trigger another slide and another dip, and that takes a lot of healthy institutions with it. Not that that would happen, but I think we have to play a little of what if with this.

Mr. BOWSHER. That's right. And that was one of the reasons why we had raised the possibility of the administrative merger between FDIC and the FSLIC staff to give you more experienced people in these workout situations.

Mr. WOLF. Can I just toss one thing and put that in a little bit of perspective. Continental Bank was closed in, I believe it was 1983.

They are still trying to sell off some of the assets. They are still working that out. These things are very long term. We said 3 to 5 years for planning purposes. I think you are probably looking at a 10-year type of program to get rid of many of these assets. I don't think it is going to happen very fast. In the meantime, you have to deal with the depositors, and that is something that you have to do quickly. You have to make the funds available or the Treasury line of credit or whatever, so that the depositors can get their money out and quickly back into your economy. The assets are a long-term workout program.

Senator WIRTH. Well, gentlemen, thank you very much.

Mr. BOWSHER. But that doesn't mean that you have to have a bankrupt or insolvent institution in place for 10 years. In other words, you do just what Fred said. You pay the deposits off, then implement some kind of a workout program.

Senator WIRTH. And that's what your responsibility is.

Well, gentlemen, I thank you very much for being here, and once again want to commend the chairman for having you-all in here early on. I think your expertise and care is every impressive and is going to be extremely helpful to us. Thank you very much. Thank you, Mr. Chairman.

The CHAIRMAN. I won't keep you much longer. You've been terribly patient staying at the table this long, but we have had good active participation, and it has been very worthwhile. I think it is important in these workouts that we have on our side of the table—the Government side of the table and the people's side of the table—the professional talent and strength in staffing numbers that is sufficient to really take on the people on the other side of the table who represent private interests. I am concerned that this was not the case in December. I want to make sure that in the future we have the best corps of professional, long-term civil servants, augmented by whatever help we need, right in the center of the workouts. The December situation makes us vulnerable to bad judgment. In addition, I don't want inside dealing or friendships intruding on this fire sale.

The other day I was talking to another Senator who introduced me to someone who is involved in that work right now. He said that in one of the offices there are boxes full of files of assets that show where this money has disappeared. To get full value out of these assets, we must get into those files, understand them and the local economic conditions. That is a very complex task. There are billions and billions of dollars still at stake. I don't want somebody in the private sector to skin us a second time, because we are not paying attention or managing our way out of this problem as best we can.

I want to work with everybody here to make sure that we have a team on the public side, the people's side, that will work out the problem at the least cost. It won't be easy. It's a miserably difficult problem, that will receive talent and plenty of it to protect the public interest.

Now I want to run through several questions. I would like you to substantiate and I quote, that "The Federal Home Loan Bank System role as an industry promoter has been accorded more importance than FSLIC's risk management insurance function."

Mr. Bowsher. Well, I think if you look at the last 5 or 6 years, when we were trying to get this problem up and on the table as being a real problem, the Federal Home Loan Bank Board many times said it was not that big of a problem. I will say that when Mr. Gray was over there, he did finally realize how big the problem is. He went to OMB and tried to get some additional support and did not get the support and everything like that.

I feel even in this last year or so that there was not the recognition of how big a problem it is. The Bank Board has advocated that we can keep going the way we are, and less emphasis on the regulation that we needed. So it is really just looking at what happened here in the last year. Also, I don't think I have to explain to the committee or even the Congress that you had some trade associations here that played a very heavy hand in this debate—always taking the position that the problems weren't very large. That is when the FSLIC recapitalization legislation was reduced to $5 billion, if you remember. The trade associations were working very closely with the Federal Home Loan Bank Board. I think it has to do with the way you have it structured—the Bank Board was set up originally to be an advocate for the industry. It isn't that they are doing something that they weren't set up to do. Now that you have this situation, we ought to take a look at it, and we ought to get that separation for FSLIC, get that independence.

HOW MUCH CAN INDUSTRY AFFORD TO PAY?

The Chairman. You state that under "Under the best of circumstance, it is not likely that the thrift industry can contribute much more to the funding shortfall."

How much do you believe can be squeezed out of the industry and what are the consequences if we try to make them pay more than what they prudently can?

Mr. Bowsher. I think that is the danger. As we mentioned earlier, you don't want to drive these other 2,000 healthy thrifts down by putting too much burden on them. They are paying twice now what the banks are paying into their insurance fund. We've studied it, and we really have come to the conclusion that although solutions should involve as much as can be obtained from industry, but we aren't advocating or holding out here that we think there is a lot of money to be gained from the industry.

The Chairman. Do you think the healthy ones can continue to pay the extra premium they are now paying?

Mr. Bowsher. We would think that they will have to pay some kind of an extra premium to build up their own healthy insurance reserve.

The Chairman. But an add on beyond——

Mr. Bowsher. That might be a worrisome situation. I think it should be looked at, but we are not recommending it.

The Chairman. You criticize some of the big 8 accounting firms for not spotting the problems that many of these thrifts had developed and which caused them to fail. Sometimes the problem surfaced a very short period of time after they had gotten an outside auditor's report that certified that everything was OK.

What problems have you seen in that area and what remedies do you suggest for them?

Mr. BOWSHER. Well, we have issued that report, sent it over to the House Banking Committee. They have not released it yet, so I don't feel that I can go into great detail here, but we have done just what you've said. We've looked at 20-some institutions. We saw some problems with 6 auditing firms—6 out of 11 auditing firms, and we are referring those firms to the professional organization for that. And we have recommendations in the report as to what needs to be improved, not only by the individual firms but also by the AICPA, which is the parent group that issues audit guides and things like that.

The CHAIRMAN. I understand the sensitivity on that report until the House makes it public. But may I ask, without getting into the guts of that report, what you found that was really extraordinary. Do you think that certifications have been made on financial documents where very serious auditor errors were involved?

Mr. BOWSHER. I think it is always disappointing when you see a situation like this where the auditors didn't quite realize that conditions had changed to the point that they needed to really change their audit approach and maybe put in some extra effort and do some additional work to see if those assets really were worth anything, and if people were going to be able to repay loans, as they claimed they would.

So I would describe it as a disappointing situation that needs to be corrected and that is the effect I hope our report will have.

The CHAIRMAN. Let me ask you one other thing at this point. As you reconstruct the deals, do you have any sense yet that there was favoritism shown in the December burst of activity?

Mr. BOWSHER. I don't think we have done enough work yet that I could say, but we certainly understand why you have concern. You have asked us to look at it, and from what we have seen so far it needs looking at.

The CHAIRMAN. I want to pin that down, even if it takes until March to do so. I want this ventilated in the full light of day, so that we know exactly what happened, and whether it can withstand that kind of scrutiny.

Mr. BOWSHER. One thing that is obvious from the work that we have done so far, is that many of the safeguards that you have in Government procurement here were not followed. We can say that.

The CHAIRMAN. Well, you acknowledged earlier that the FSLIC was not able to do its own due diligence review, as far as you can tell, because of the number of deals cracked through at the same time. That certainly makes me very uneasy.

Mr. BOWSHER. Yes. I think you also have seen that there have been some lawsuits, one that I am familiar with, that have already been filed by some disappointed groups, so that will come out.

The CHAIRMAN. Senator Wirth.

Senator WIRTH. Mr. Chairman, the allegation was made a little earlier in the hearing here that in the process, one of the reasons that the FSLIC had to do what they did was that they were waiting for the Congress. We didn't give them enough funding or authority to do what they wanted to do. I remember a hearing right here in which Mr. Wall and Mr. Gould, who was then the Under Secretary of the Treasury, sat where the gentlemen from the GAO are sitting this morning. And they were asked very specifically by a number of members of this committee if, in fact, they needed more funds, and the answer at that point from Mr. Wall and Mr. Gould was no. And they said to us, no, everything was all right. They had everything that they needed.

The **Chairman**. I remember the hearing.

Senator **Wirth**. This is August. Now, you know, if you were somebody who's been around the city as long as Mr. Wall has, and you know, has observed as much as Mr. Gould has from his perspective in New York before coming down here, that in August of an election year, you got a pretty small window of getting the attention of the Congress. September comes when you are trying to finish all the legislation, and people are scattering as rapidly as possible, particularly in a fourth year where you have a Presidential campaign coming up.

So they were given the opportunity, and it seems to me it is a bit disingenuous, and I say this at this point, you know, just to clear the record, Mr. Chairman, to suggest that one, that the FSLIC was waiting for the Congress. And second, to make sure that the records shows that offer was made to Mr. Wall and to Mr. Gould, the question was asked very, very clearly, you know, in this committee. And that now to begin to suggest that somehow because they were "waiting for the Congress," all of these problems occurred. That simply is not the case, and the record doesn't show that. There is plenty of blame sure to go around, in terms of lousy pieces of legislature that were passed and too much authority given to people to operate and so on, but to at this juncture start to point a finger and say that the FSLIC was waiting for the Congress simply isn't borne out by the record.

Mr. **Bowsher**. I think Mr. Wolf was testifying that day or very close to that day, representing us, and he gave an opposite picture. In other words, we thought it would be much better if the problem be acknowledged and recognized at that time.

Senator **Wirth**. I remember that very well, and he also testified in front of the Budget Committee a little later, and that was in September, in which we went through the same drill. And we were getting back the "no problem" response from everybody except you-all and one other outside individual whose name I don't remember.

The **Chairman**. I think that is an important enough point, which shouldn't be subject to dispute. So I am going to ask the staff to review the committee record at that time here and in the Budget Committee and pull out the critical questions and the answers on that precise point and put it in the record at this point. That way, we don't lose sight of the content and the continuity of these discussions.

[The following information was subsequently submitted for the record:]

An examination of hearings held in 1988 reveals the following with regard to the issue raised in the subject hearing as to whether the Treasury Department or the Bank Board had requested assistance for the FSLIC fund.

On May 26, 1988 the following exchange between members and Chairman Wall of the Federal Home Loan Bank Board took place in the Banking Committee: [see attached material].

Senator **Bond**. Let me just start off with a broad question. You have mentioned the things that you have done in restructuring the agency. Are there any things that you see necessary for Congress to do this year. You mentioned the moratorium. Are there other things that need to be done in the interim before we take a review next year of your progress?

RECOMMENDATIONS

Mr. **Wall**. Well, as a minimum, we have been before the Finance Committee and have been doing a lot of visiting with various Members of both the House and the Senate, as we could have the opportunity, to talk about what a change in the tax laws that applies to FSLIC, beginning effective January 1, 1989. Until then, assistance FSLIC provides is not considered as taxable by the recipient entity, whether it be an investor or whether it be an existing institution.

After January 1, 1989, that assistance will be tax-treated by the recipient company or investors, so as to, in a sense, increase our costs. We are asking that the Congress extend that exemption for FSLIC insurance tax treatment. We also have been supporting the FDIC's request that they be added to the special treatment provision. They are not currently tax-exempt. We are supporting the exempt treatment to them as well.

It is, I think, of everything that needs to be done, other than the question of the moratorium or dealing with teh question of departures or switching and a perception problem related thereto, the most important one.

We then get off into other things that you as a very active and good lawyer are familar with-the so-called Hudspeth issue, and the more recent Tickton issue. These deal with the authority that FSLIC has to operate as an insurance entity within the legal structure, and whether or not we have to take our recourse in State courts rather than Federal courts and other various, arcane questions, to at least the layman. But these are important ones to FSLIC, and in an insurance sense, and in an operational sense.

Senator **Gramm**. Danny, as you are aware, there have been a lot of people in front of this committee and a lot of talk around town from people with faint hearts and open palms about a taxpayer bailout. [Laughter.]

I am committed to the idea that with enlightened public policy we can avoid a taxpayer bailout.

Do you believe we can do that?

NO TAXPAYER BAILOUT FORESEEN

Mr. **Wall**. We believe that the numbers are such right now that barring any significant shift in our assumptions in the economy, generally, we are within striking distance of having dealt with all of the problems with the resources available. Now I am not Pollyanna to say that absolutely, without question, but we are clearly within range, and it is clearly appropriate for the Congress and for the industry to give us the time to utilize those resources and for the next President and the next Congress to look over our shoulder and into our closets as to what success we have had and what problems remain if any.

Senator **Gramm**. Well, obviously, we don't know what is going to happen in the future. We don't know how the program is going to work, but you believe, based on the data you have right now and the experience that you have had in implementing your plan, that you can avoid a taxpayer bailout; is that right?

Mr. **Wall**. We believe we have the resources available that, as I say, put us within striking distance of the problem, barring any unforeseen shifts in the economy.

On August 2, 1988 the following exchanges took place between Under Secretary George Gould of the Treasury Department and members of the Senate Banking Committee: [see attached material].

STATEMENT OF GEORGE D. GOULD, UNDER SECRETARY FOR FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. **Gould**. I thank you, Mr. Chairman, and I thank you, Senator Garn. I sometimes find, Senator, not really here but in many places that my statements don't really change people's reactions or questions, so I'd be happy to have you go forward with your questions if you'd like.

The **Chairman**. We want to hear your words of wisdom. We really do.

Mr. **Gould**. I will try to keep within your 10-minute rule.

Mr. Chairman, Senator Garn, and members of the committee, I appreciate this opportunity to return again today to testify on the condition of the Federal Savings and Loan Insurance Corporation [FSLIC]. Specifically, I will comment on why, from the administration's perspective, it is unnecessary to transfer resources from the American taxpayer to FSLIC so FSLIC in turn can close—or warehouse—insolvent savings institutions in this country.

I also am struck by the number of academics and consultants who are quick to jump to a taxpayer remedy as the solution to FSLIC's problems. I am amazed at how quick some observers are to give up hope of resolving the problem by existing means and to rush to use someone else's money—yours and mine.

As I stated in my 1986 testimony to this committee:

"Anyone's estimate of the cost of resolving problem thrift cases entails considerable uncertainty. The hesitation is partially attributable to important variables—such as interest rates and regional real estate conditions—that may affect significantly the health of many institutions over time."

It is my understanding that Federal Reserve Board Chairman Alan Greenspan took a similar position during his recent appearance here. Rather than focus on numbers in the future that no one really knows, we should instead focus on numbers for which we can account. We know, for example, that over the next 3 years FSLIC will have about $19 billion to close insolvent institutions—as much as it says it can handle efficiently—and Chairman Wall has testified that $42 billion is available over 10 years for that same purpose.

Before we rush to a transfer of funds from taxpayers through FSLIC to insolvent institutions, we really ought to exhaust all other available resources. I should think that all committee members would be on their guard against a general taxpayer bailout for managers of failing and failed institutions, particularly since any such bailout would be charged to the committee's annual budget allocation and force harder choices among other programs under the committee's jurisdiction that already compete for limited resources from the Federal Government.

If Congress wants to take further steps to put the administration's strategy in place, I can suggest the following steps to help both FSLIC and the thrift industry before you call on the American taxpayer. Let me just list these for you briefly; and we can discuss them in the Q and A: More recapitalization financing; thrift charter enhancement; facilitate acquisitions; use private capital to back additional State-chartered authorities instead of FSLIC-insured funds; strengthened enforcement authority; and extend expiring tax provisions.

In closing, I urge this committee in the strongest possible terms to resist mounting pleas for an unnecessary, budget busting bailout of FSLIC. The precious resources of our taxpayers should not be tapped until the existing plan has had a chance to work and all other reasonable available resources have been used. In any case, no single change in existing mechanisms should be made without reevaluating the full array of institutional arrangements.

Important strides have been made in all three areas of the administration's 1986 plan, although there is still more to do. Programs now in place should be given time to work—and a better data base assembled—before taxpayer money is thrown at the problem. All existing resources should be utilized first and all non-expenditure solutions should be implemented. Obviously, more steps along the line I have suggested can and should be taken.

If additional resources become necessary at a later date, then the Bank Board, the administration and the Congress will have time—and the obligation—to carefully reconsider the full range of interrelated policy issues with respect to our regulatory and deposit insurance structure.

Senator **Graham**. Assume that the problem is on the low side, a $30 billion problem. What do you believe Congress should do between now and our adjournment in October?

Mr. **Gould**. Well, in my opinion, Senator, if you believe that that is the size of the problem, and as I do, that the Bank Board is moving as expeditiously as it is organized to do, than I think it is not necessary to do anything between now and November.

If you proceed into next year at the rate of two resolutions a week you're going to learn something about the costs. Then if you want to review the situation again next year, I would suggest and really ask very strongly that you do it in the context of looking broadly at the whole public policy issue of the role of deposit insurance.

Senator **Graham**. The second question in the same vein, is if the problem is of the high side of the envelope, a $70 billion problem, what do you think Congress should do in the next 60 days?

Mr. **Gould**. Well, I don't think you ought to appropriate $70 billion because I think it's going to require a lot more analysis.

Senator **Graham**. Affirmatively, what should we do? An affirmative answer would be nothing?

Mr. **Gould**. If I believed it were $70 billion, I would consider something like I believe this committee has already passed—a commission to come back very early in the next year. I thought in my reading of it that was a good commission blueprint because it's quite broad, and if it's $70 billion you've got to look broadly at this.

Senator **Graham**. So the answer is under any scenario—low side or high side of the problem—you believe for the next 60 days—that is, for the duration of the 100th Congress—that the appropriate response is no response?

Mr. **Gould**. Would you give me a moment to try to clarify that? Conceptually I think this is the way you should look at it.

FSLIC is a workout fund. It's not an insurance fund. It doesn't have enough money in it to be an insurance fund. It won't have enough money in it to be an insurance fund. It's a workout fund for troubled thrifts.

You gentlemen are the insurance fund and as long as you remain, as the chairman said in his opening remarks, telling the depositors that they are secure, then I do not see that you have to work out anything between now and November.

Senator **Graham**. The question I asked was not what should FSLIC do or the Home Loan Bank Board. I asked what should Congress do, accepting the fact that we are ultimately responsible.

Mr. **Gould**. The only problem you're going to have or the only "crisis" that could occur between now and the opening of Congress next year would be deposit related. In my view, there is enough money to continue down the path they are on. As long as Congress stays behind the depositors, then I think there's time for a commission or a group or a study. If the problem is $70 billion, I think a study would be a very good direction to go.

QUESTIONS FOR UNDER SECRETARY GOULD FROM SENATOR PROXMIRE AUGUST 2, 1988 HEARING

Question 1:

How much additional money can the thrift industry contribute to industry clean up?

Answer:

Currently, the only money, in addition to the regular premium of 1/12 of one percent of deposits, that the industry has contributed to the Federal Savings and Loan Insurance Corporation (FSLIC) is the 1/8 of one percent special assessment which began in 1985.

As I indicated during the hearing, continuing the special assessment for 10 years may be too long, but we believe the industry can handle this 1/8 of one percent special assessment for some additional time as determined by the Federal Home Loan Bank Board: that is, until the current program, which includes only a partial recapitalization of the FSLIC (that we requested in March 1986), some regulatory reform and charter enhancement, begun over a year ago, has been completed and had a chance to work. Congress will then have a better data base to evaluate the progress of the Bank Board's efforts.

Question 2:

For how many years should the special assessment be continued?

Answer:

At this time, it is unclear for how long the special assessment should be continued by the Federal Home Loan Bank Board (FHLBB). However, since the FHLBB evaluates the need for the assessment and the ability of the industry to pay it on a quarterly basis, the assessment will only be continued for as long as the FHLBB believes it is necessary.

Question 3:

Where should Congress obtain the funds that will be needed to resolve the savings and loan industry's problems?

Answer:

The FSLIC's projected cash flows show that it will have about $19 billion over the next three years to resolve the problems of troubled thrifts. The Bank Board has said that these resources are all it needs at this time, and that additional funds are currently not necessary. However, we understand that both the Bank Board and the General Accounting Office are revising their estimates and will report to Congress in the near future.

As I specified in my testimony and again in my answer to question seven, which follows, there are a number of ways Congress can help to reduce the FSLIC'S problems before providing additional money. In addition, in my opinion, before any more funds are made available the new Administration and Congress should evaluate the impact that the federal deposit insurance system has on the willingness of the managers and owners of financial institutions to take imprudent risks. Some structural reforms must be enacted to provide the proper incentives which will strengthen our financial system and protect depositors and taxpayers.

If additional funds are required, the FICO structure could be used at a relatively small annual cost to obtain sizeable amounts of resources, as I indicated in my testimony. The remaining Federal Home Loan Bank surplus could buy additional zero-coupon Treasury securities to repay the principal amount of additional FICO bonds. Some of the interest on these bonds could be paid by continuing the special assessment, while other sources to cover the interest payments would have to be examined and evaluated.

Question 4:

Do you believe that the savings and loan industry (often through its trade associations) has undue influence in the regulation of the industry? What do you think should be done to reduce the industry's control?

Answer:

If Congress believes the savings and loan industry has too much influence over its regulator, then it can hold hearings and ensure uniform treatment in all areas of capital, supervision, examination, and accounting. One way to lessen any perceived industry influence might be to insist that both bank and thrift regulators have the same regulatory requirements and standards for examination.

On October 5, 1988 the following exchange took place between Chairman Wall of the Home Loan Bank Board and members of the Senate Budget Committee: [see attached material].

[Materials supplied is from original hearing transcript:]

Mr. Wall. I am today providing this committee with FSLIC's most current estimate of the cost of resolving all GAAP-insolvent institutions. We project that cost to range between $45 and $50 billion.

Chairman Chiles. Well, is it true, then, that you have effectively doubled your estimate of the present value of your prospective losses since the first of the year?

Mr. Wall. It is.

Chairman Chiles. How are we going to pay for that?

Mr. Wall. What it requires in terms of the existing authority that we have—and that is all that we can call on and that is all that we can quantify; that is, it could require the extension of the special assessment for 30 years. That is existing law. That is all we have the authority to utilize.

Chairman Chiles. Tell us what that means.

Mr. Wall. That means, in a sense, going back to what I said initially as far as deposit insurance having been under-priced all of these years, it might be that Congress will be or that we would be in the position of imposing a more appropriate level of premium on our industry. However, the Congress has to keep in mind that that would be then an uneven or unequal kind of a burden for the thrift industry to carry visa-a-vis the banking sector.

Chairman Chiles. So that is a tripling of the length of time for the special assistance.

Mr. Wall. For the special assessment, yes.

Senator Domenici. Some say that you have entered into more of the promissory notes and the maintenance agreements, than you are going to be able to repay. Do you agree with that statement?

Mr. Wall. No.

Senator Domenici. What options would you have to resolve problem cases in the absence of these arrangements or other Congressional action?

Mr. Wall. As we see it, vertually none.

Senator Domenici. Have we used taxpayers' dollars in the past for that assurance responsibility?

Mr. Wall. No.

Senator Domenici. Are you telling this Committee, based on what you know now—and I assume you have had time to really get into the FSLIC obligations—are you telling us that we are going to have to use taxpayer dollars to pay what I have just described? Now we have a lot of those, we have accumulated them, you have put together packages, you have issued notes, you have issued maintenance agreements, you are collecting assessments from the industry.

Can you tell us whether we are going to have to have taxpayer dollars or not?

Mr. Wall. We are saying that under the law as it exists, which does not give us the ability to impose any obligation on the taxpayers, under the laws as they exist there are sufficient resources that we can access.

Again, it extends that special assessment over a very extended period of time. The Congress needs to deal with it.

Senator Domenici. But why do you call it a special assessment?

Mr. Wall. That is what the law provides. There are two levels of premium assessments that can be made. The regular premium has been the 1/12 of 1 percent that goes back to the 1930's, and the special assessment authority that we have is an additional 1/8 of 1 percent.

Senator Domenici. So it is special in the sense that it is more of an assessment than the normal one that existed for most of history, but it has been on for how long?

Mr. Wall. Since early 1985.

Senator Domenici. And you are saying if that continued for 30 years, that seems to you to be enough to take care of the responsibilities as you know them?

Mr. Wall. Yes, we have present-valued the returns from that over 30 years.

Senator **Danforth**. Mr. Chairman, my understanding is that if we do nothing, the FSLIC—or if nothing is done, FSLIC does not have the resources to pay off the depositors in bankrupt savings and loans. Is that the long and the short of it?

Mr. **Wall**. No, we believe we have the resources if we are permitted to continue as we are.

And we would be even better prepared or better equipped if the full faith and credit question were taken out of the debate as far as the accounting profession is concerned.

Beyond that, if the Congress wants to direct us to do it in a different way, then they will have to give us some different tools.

Senator **Danforth**. Well, my understanding from your testimony is, the possibilities are either assessing the savings and loan to provide the resources for taking care of the depositors, or getting the money from somewhere else; is that it?

Mr. **Wall**. Well, under the current law, we have only the ability to assess the industry.

Senator **Danforth**. Yes. But we are here as policymakers. And my view is really different from Senator Riegle's. I am not interested in all the details of each transaction. I am interested in what, if anything, Congress is supposed to do about this situation in the next year or so.

So as I understand the situation, the money is either going to come out of the savings and loans that are still in existence, the healthy savings and loans, or the money is going to come from some other source.

Mr. **Wall**. That is right.

Senator **Danforth**. Now, with respect to the assessment against the savings and loans, you think that the problem can be resolved if only we extend the duration of the special assessment. You are not calling for any—you do not think it would be necessary to increase the assessment that presently is in existence other than in time?

Mr. **Wall**. What we are saying is, with the authorities that exist, the only thing we can do——

Senator **Danforth**. I am not asking what you can do. I am just asking about the options that are available to all of us.

Mr. **Wall**. I think the options that Congress has available to them, and I think the basic point is to look at deposit insurance in its entirety.

It has been underpriced historically. So maybe the recognition and the fact that we are now levying a higher premium should well have been the case on both sides, both the FDIC and us. And maybe the Congress needs to evaluate that for FDIC as well as for the FSLIC.

Senator **Danforth**. OK, could or should the problem be resolved by simply extending in time the special assessment? Or would it be necessary to increase the assessment?

Mr. **Wall**. Are you speaking from your perspective or from ours?

Senator **Danforth**. Well, just as a practical matter, can the problem be solved? Would the resources be there to solve the problem if we simply extended in time the special assessment without increasing the total amount that the S&L's are assessed?

Mr. **Wall**. It is a matter of what other impact can we or you or the market have on the cost of funds for those institutions. If they have to pay a higher premium, a higher cost of doing business, they have to be able to offset it somewhere.

Are they able to lower their cost of funds some other way, pass that on to their depositors or their borrowers? If the industry is being looked to in a vacuum, the industry has to find a way to accommodate the pressure.

Senator **Danforth**. But I mean are you suggesting that you have to increase the existing pressure on the industry? Or that you just have to keep the same pressure going for 30 years instead of for a shorter period of time?

Mr. **Wall**. We are saying that to extend the special assessment—you characterize it as the same pressure for 30 years—would solve the problem as we see it.

Now, on the other hand, the industry would be in a competitive environment. And how do they compete with their competitors? That being other kinds of financial providers, not just commercial banks obviously, in this case.

Senator **Danforth**. And they feel that they would be severely disadvantaged. Do you agree with that?

Mr. **Wall**. I think it would come at a severe disadvantage, and there would be a struggle. It would be difficult for the industry to shoulder the burden for a 30-year period.

STATEMENT OF

M. DANNY WALL, CHAIRMAN

FEDERAL HOME LOAN BANK BOARD

BEFORE THE

COMMITTEE ON BUDGET

U. S. SENATE

II. FUTURE

Financial Regulators Enforcement Initiative

The bank regulatory agencies, including the Bank Board, have invested significant time and resources to produce jointly a legislative initiative that would enhance our enforcement authority. This initiative, which has incorporated as Title VI of S. 1886, the Proxmire Financial Modernization Act of 1988, has the support of all the banking agencies. Some months ago, there were indications from Congress that this initiative would be passed this year. I urge you, in these last days before adjournment, to enact the enforcement initiative.

The **CHAIRMAN**. Anything else?

[No response.]

The **CHAIRMAN**. Let me now announce the final vote tally on the two nominations that the committee considered early in the day.

Michael Boskin, to be Chairman of the Council of Economic Advisers, was reported out unanimously, 21 to 0, and the same for Jack Kemp to be Secretary of the Housing and Urban Development Department.

Let me just now say to the three of you, I appreciate very much the work that you are doing and your testimony today. Through you, I want to thank your colleagues and their staff who are burning late night and weekend oil to meet the requests we have given you. It is very important work; it is profoundly in the public interest. We are grateful for it, and I appreciate your testimony and your directness today.

Mr. **BOWSHER**. Thank you very much.

The **CHAIRMAN**. The committee stands in recess.

[Whereupon, at 1:20 p.m., the hearing was adjourned.]

[Response to written questions follow:]

HEARING OF FEBRUARY 2, 1989

GAO's Response to Questions received from Senator Riegle subsequent to GAO's February 2, 1989, testimony before the Senate Banking Committee on problems facing the Savings and Loan Industry.

QUESTION 1:

Thrifts that are currently healthy will find their competitive environment improved when the dead thrifts are buried. Healthy thrifts' earnings should then improve. Do you believe that the strong thrifts -- those that survive without direct assistance -- should contribute part of their increased future earnings to defray some of the costs being borne by the taxpayers? Please suggest ways to achieve the objectives of having those that benefit contribute to meeting the cost?

ANSWER 1:

Healthy thrifts certainly operate at a competitive disadvantage to insolvent thrifts and thrifts currently receiving FSLIC assistance guarantees, forbearances, and tax savings. We believe that the competitive environment of the healthy thrifts will be improved once the FSLIC situation is resolved.

Although we would like to see the thrift industry contribute as much as possible to the cleanup of the current crisis, given the magnitude of the funds needed to restore FSLIC to financial health, it is not realistic to expect the thrift industry to pay the entire bill.

The Administration's recent proposal for solving the FSLIC crisis obtains additional financing (about $6 billion) from the industry by tapping the earnings of the Federal Home Loan Banks. The proposal calls for an increase in premiums for thrifts to 23 basis points per $100 of deposits from the current 20.8 basis points. The increase would be effective from January 1, 1991, to December 31, 1993, after which, the premium rate would then be lowered to 18 basis points. The net effect of this premium structure is a $1.6 billion reduction in the amount of premiums paid by thrifts between 1989 and 1999 compared to the premiums that would be collected for the same time period under current legislation.

Our report suggested another way to achieve a modest increase in the effective industry contribution above that included in the Administration's plan. We recommended that a larger share of the money obtained from the industry over the 1989-1999 period be used to establish reserves for the insurance fund for healthy thrifts and that this contribution be accelerated. We suggested, for example, that this could be done by a capital levy on healthy thrifts of up to 1 percent of deposits. By making such a charge on healthy thrifts and by earning interest on the reserves that are built up, we calculated the contribution that would have to come from the Treasury might be reduced by about $5 billion. However, for such an arrangement to be practical, the institutions placed in the insurance fund for healthy thrifts would probably have to have levels of GAAP capital of at least 3 percent. Otherwise, the contribution to reserves could precipitate additional insolvencies.

QUESTION 2:

Do we need a separately regulated thrift industry? What is the thrift industry's role in providing financing for the nation's housing?

ANSWER 2:

While thrifts are still important and active participants in all phases of housing finance, particularly origination of residential mortgage debt, the share of assets thrifts devoted to mortgage activity has declined by 20 percent in this decade, and their share of total residential mortgage debt has declined by more than 15 percent. Securitization has reduced the role of a single specialized and protected housing lender and has created intense competition in the mortgage market by attracting many new participants into the mortgage market, both as providers and holders of mortgages. The thrift industry and housing finance are in a transitional period. An important public policy question arises if we wish to continue our historic commitment to housing in this environment. Consideration should be given to the question of whether the subsidies and benefits provided thrifts to encourage the provision of housing finance might appropriately be provided to any financial institution demonstrating the same commitment to housing.

Background

The Federal Home Loan Bank System (FHLBS), which consists of the twelve regional Federal Home Loan Banks under the supervision of the Federal Home Loan Bank Board (FHLBB), originated with the Federal Home Loan Bank Act in 1932. The Act was a response to the Great Depression, which had undermined the nation's banking system and disrupted the housing market. Because of housing's great social significance, there was an urgent need for a system to ensure the availability of funds for housing finance.

The federal government entered into the regulation of the savings and loan industry to remedy this disruption in the housing market. The main purpose of the the FHLBS was to financially strengthen member savings and loan associations by providing them with an alternative and steady source of funds so as to promote home ownership. A separate system of laws and regulations, tax rules, deposit insurance, accounting standards and incentives arose to encourage thrifts as specialized housing lenders.

Changing Role of Thrifts in Mortgage Lending

Through the late 1970s, more than 75 percent of thrifts' portfolio of assets consisted of conventional fixed-rate mortgages[1] financed by short-term passbook savings deposits. At year-end 1979, the share of residential mortgage assets in thrifts' portfolios was 76 percent. Mortgage loans on the traditional thrift asset, 1-4 single family units, comprised 69.6 percent of thrifts' assets.

Thrifts' have also dominated residential mortgage finance in terms of mortgage debt outstanding and mortgage originations. From the late 1950s through the end of the 1970s, thrifts' share of total mortgage debt[2] outstanding ranged between 40 and 50 percent, and for most years between 1960 and 1980, thrifts' share was between 44 and 46 percent. Banks' share of this mortgage debt outstanding over the same period rose from 14 to 18 percent. Life insurance companies' share significantly declined from 20 to 9 percent, while that of federal and related agencies and private mortgage pools rose from 24 to 32 percent.

Thrifts' share of residential mortgage originations has been between 35 and 47 percent throughout the 1980s.[3] At September 1988, thrifts' share of originations was 42.9 percent, approximately a 5 percentage point increase over their share of originations in both 1986 and 1987. The respective shares for banks and mortgage companies at September 1988 were 24.9 and 22.6 percent.

Dramatic changes occurred in thrifts' balance sheets concurrent with the severe recession in the early 1980s. The serious inflation and rising interest rates of the late 1970s and early 1980s exposed the inherent weakness of thrifts' long-term fixed-rate mortgages funded by short-term deposit liabilities. In response to the situation, Congress passed the Depository Institutions Deregulation and Monetary Control Act (DIDMCA), which made extensive changes on the liability side of the depository institutions' balance sheet. Adjustable rate mortgages (ARMs), which had been allowed in some states since the 1970s, were authorized for federal thrifts in all states in 1979.[4]. And in 1982, Congress passed the Garn-St Germain

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[1] Conventional mortgage assets consist of residential mortgages on 1-4 single family and multifamily dwellings.

[2] The historical data available on total mortgage debt includes 1-4 family houses, multifamily properties, and commercial loans on all properties.

[3] The 35 percent low point occurred in 1982, the recession's trough.

[4] At September 1988, ARMs made up 53% of thrifts' net mortgage loans, contracts and pass-thru securities, up from 5% in 1980.

Depository Institutions Act to further broaden thrifts' asset powers. It was believed that thrifts would use these broadened powers to diversify their portfolios and thereby strengthen their position while they continued to provide housing finance.[5] This worked for some thrifts. However, for thrifts already weakened by the huge losses they incurred when they were caught between their mandated commitments to long-term fixed-rate mortgages and the unprecedented higher costs paid on deposit accounts with the newly floating rates, expanded powers provided an opportunity to gamble for survival.

While mortgage assets continue to represent the major share of thrifts' total assets, following the thrift crisis and the advent of expanded powers, thrifts' mortgage assets as a share of total assets declined to 59.2 percent as of September 1988. The mean portfolio share of mortgages for 1-4 family homes, the traditional thrift mortgage asset, fell even further, from 69.6 percent in 1979 to 37.4 percent in September 1988. Thrifts' share of total mortgage debt outstanding also began to decline, while that of federal agencies and private mortgage pools rose. At September 1988, thrifts' share of total residential mortgage debt outstanding had fallen to 31.9 percent, while federal agencies held 36.9 percent, commercial banks, 14.4 percent, life insurance companies, 1.6 percent, and others, 12.7 percent.

Profitability of Thrifts in Mortgate Lending

The profitability of thrifts that remained in housing coincided with industry profitability from 1980 to 1984. Since 1984, portfolio lenders, thrifts holding at least 50 percent of their assets in the form of conventional 1-4 single family and multifamily mortgages, and Qualified Thrift Lenders (QTL)[6], thrifts that have at least 60 percent of their assets in mortgage-related securities including mortgage-backed securities (MBS), have outperformed the rest of the industry.[7] Part of the reason that thrifts with mortgage-related assets have done better than the industry since 1984 is that most of this period was marked by slowly declining and relatively stable interest rates, a particularly favorable condition for mortgage lending. Also, the overall poor performance of the industry is dominated by the very dismal performance of the worst of the insolvent thrifts, whose portfolios, on average, contain a greater share of nonmortgage assets than the industry.

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[5] The DIDMCA expanded the authority of Federal savings and loans to invest up to 20 percent of assets in consumer loans, commercial paper, and corporate debt securities and to invest in, sell, purchase, participate, or otherwise deal in real estate loans or interest therein without geographic restriction. The Garn-St Germain Act allowed thrifts to invest up to 5 percent of assets, until January 1, 1984, and up to 10 percent, thereafter, in commercial corporate, business or agricultural loans; to invest up to 10 percent of assets in obligations of the state or local governemnts; the limitations on the proportion of total assets invested in nonresidential real estate loans was increased from 20 to 40 percent, and the limitations on consumer loans were changed from 20 to 30 percent of assets.

[6] The definition of a 'Qualfied Thrift Lender' (QTL) was enacted in the Competitive Equality Banking Act of 1987 (CEBA). To be a QTL, a savings institution must have 60 percent of its tangible assets in residential real estate related investments in three

It would be a mistake to infer from recent profitability trends that remaining devoted to housing is the way for the thrift industry to resolve its problems. The lesson of the early 1980s is that portfolio lenders do not do well in an unpredictable and high interest rate environment.[8] The maturity mismatch weakness can be overcome, to some extent, by use of adjustable rate mortgages and/or hedging techniques. However, rising interest rates can cause difficulties and losses even in the most carefully managed situation.

Profitability and Capitalization

Our work shows that capital, not asset category, continues to be the dominant characteristic associated with a thrift's performance. Differences in profitability, as measured by return on assets, are associated with a thrift's capitalization level more strongly than the portfolio's asset categories. Insolvent and poorly capitalized thrifts do poorly whether they are in traditional or non-traditional activities.[9] Well-capitalized

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out of every four quarters for two out of every three years.

[7] There is considerable overlap between these two groups. For example, at September 1988 there were 1,379 portfolio lender thrifts, and 1,215, or 88 percent, were also QTL thrifts.

[8] Portfolio lenders can do well in a declining interest rate environment.

[9] A poorly managed non-traditional portfolio will probably perform worse than a poorly managed traditional portfolio because non-traditional assets generally have a higher variability of return and the thrifts' managers have to develop a new set of skills and expertise when they enter into previously untried investments. Also, the moral hazard problem is especially acute with insolvent thrifts. With no capital of their own at risk, and under the current flat-rate deposit insurance regime, these thrifts have no incentive to carefully manage their portfolios. Instead they have every incentive to gamble recklessly for

thrifts tend to do well in both traditional and non-traditional activities. In effect, 'well-capitalized' appears to be a reasonable proxy for 'well-managed'.

Factors Affecting Thrifts' Commitment to Housing

While thrifts are still important participants in the housing market, there has been a clear movement away from traditional mortgage finance activities since the early 1980s.

Laws and regulations, access to Federal Home Loan Bank advances, favorable tax treatment and other incentives, and a developed expertise in housing finance encourage thrifts to remain in mortgage finance. On the other hand, reasons for thrifts to remain in their traditional role of originators, lenders, and holders of mortgages have become less compelling. Thrifts are now permitted to invest in a wider range of activites, the tax incentives for mortgage investments have been reduced, and the development of mortgage-backed securities has made it easier for a wide and growing range of nonthrift investors (banks, insurance companies, pension funds) to originate or hold mortgages, without the interest rate risk that once had to be borne by thrifts[10].

Securitization of mortgage debt has also created intense competition which has reduced the profitability of mortgage lending making it less attractive to thrifts, while simultaneously allowing banks to act more like mortgage bankers. The proposed risk-based capital requirements for banks, which favorably weight mortgage-related securities guaranteed by U.S. Government agencies, will strengthen banks' demand for securitized mortgage assets, reinforcing the negative effects of securitization on the thrift industry. As some banks continue to expand their commitment to housing finance, an important public policy question arises about whether to provide the same benefits and advantages to all financial intermediaries demonstrating a comparable commitment to housing.

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survival.

[10] When the Bank Board was created in 1932, the need to hold mortgages was inescapable because there was no way to separate origination from financing and holding mortgages. Now, however, any thrift can separate the origination and service functions from the need to finance and hold mortgages. In seeking more of their income in the origination and servicing of mortgages while simultaneously reducing their risk in holding individual mortgages, thrifts are acting more like mortgage bankers (who originate and sell mortgages). See R. Dan Brumbaugh, Thrifts Under Seige, pp.151-171.

The Future of Thrifts in Housing

At issue is whether the housing industry requires the protective mantle of the thrift industry regulatory umbrella to ensure an adequate supply of finance for the housing industry or whether the supply of mortgage credit would dry up if the regulatory umbrella were significantly diminished? A related issue concerns the viability of thrifts in the mortgage lending business.

Securitization of mortgage-related assets has dramatically affected the market for housing finance and thrifts' participation in this activity. The greater liquidity and reduced interest risk of a mortgage asset repackaged into fragments has attracted many new participants from non-depository sources into the mortgage market. Since involvement in residential mortgage loans no longer means that the originator must also finance and hold the loan, this reduces the need for a single specialized and protected housing lender to provide housing finance.

More than one-third of the outstanding stock of home mortgages are now held in securitized form. The ability of thrifts as holders of mortgages to survive in this environment may be of greater concern than the dependence of mortgage credit on thrifts. The intense competition and narrowing margins as a result of these new lenders, along with probable future periods of rising interest rates, may have reduced thrifts' long run ability to fulfill their traditional role as housing lenders. Only thrifts with a low cost of operations will be able to survive as portfolio holders of mortgages.

QUESTIONS 3:

What powers are appropriate for federally insured savings institutions? Are there any powers which are too risky for federally insured thrifts?

ANSWER 3:

Currently some powers of thrifts, particularly for equity investments in real estate and other activities, go beyond banks' permissible activities. However, well-capitalized thrifts in non-traditional activities perform comparably to well-capitalized thrifts in traditional activities, while poorly-capitalized thrifts tend to do poorly in all activities they undertake. No studies have been able to demonstrate that participation in risky (non-traditional) activites is related to a thrift's failure, though a number of studies have related thrift failure to management-related weaknesses. If 'well-capitalized' is a reasonable proxy for 'well-managed,' then it may be more correct to determine what regulatory and insurance reforms can alleviate the problem of 'risky institutions' rather than what risky activities to prohibit. The choice of whether and which activites to restrict is a public policy question that depends on broader attitudes toward inequities, tradition, and the larger vision of the direction of the financial services industry.

Background

The massive failures of savings and loan associations during the Depression severely disrupted the flow of funds to housing. The Federal Home Loan Bank Act of 1932 was a response to this crisis. The Act created the Federal Home Loan Bank System (FHLBS), whose purpose was to strengthen the industry by providing savings and loans with a source of funds so as to ensure a stable flow of funds into the housing seqtor. This housing mandate was reflected in both the specialization of the savings and loan associations balance sheets as well as in the federal government's regulation of the industry.

The assets and liabilities of commercial banks tended to be both different in nature and in term to maturity than those of thrifts. The rationale for the regulation of commercial banks was to preserve the safety and soundness of the payments mechanism; for the thrifts it was primarily to ensure the availability of housing finance.

Regulation and tradition maintained these institutional differences until serious inflation and high interest rates brought on the turbulence of the late 1970s, which permanently changed the way thrifts do business. The interaction between market interest rates and reduced regulatory constraints led to extensive changes on the liability side of the balance sheet.

The passage of the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) in 1980 and the Garn-St Germain Depository Act in 1982, broadened thrifts' asset powers permitting them to engage in commercial and consumer lending and direct investment activities, including equity interests in both real estate and service corporations as well as the purchase of equity securities.[1]

Expanded Powers and Public Policy

Currently, some powers of thrifts, particularly for equity investment, go beyond banks' permissible activities.[2]

Clearly the range of permissible activities that depository institutions in general, and thrifts in particular, should be allowed to engage in is an important public policy question affecting the future of all depository institutions. The choice of whether and which activities to restrict depends on the broader attitudes toward several issues: (1) the traditional separation between banking and nonbanking type activities; (2) the unfair competition that exists where access to mispriced insured deposits gives an institution an implicit subsidy; and (3) the leveling of the playing field among all depository institutions, particularly given the increasing similarity of commercial bank and thrifts' balance sheets, which suggests that they should be regulated consistently.

Expanded Powers and Risk

The discussion of the issues underlying the question of what thrifts and banks should be allowed to do is often framed in the context of risk. That is certain activities are "too risky" and other activities are "safe". However, the degree of risk associated with particular activities is not always the only, or even the most important, factor to consider when determining what should be allowed. Lessons drawn from the experience of the thrift industry help to illustrate this point.

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[1] In June 1987, the Bank Board expanded the definition of direct investments to include land loans and nonresidential construction loans with loan-to-value ratios above 80 percent and renamed the expanded assets group 'equity-risk investments'. See Report on Direct Investment Activities of FSLIC insured Institutions, Federal Home Loan Bank Board to committees, February 10, 1989

[2] The non-recourse lending by banks for commercial real estate development projects, with thin borrower equity positions, often puts the bank lenders in a position where they are very close to equity investors. (Greenspan testimony, Feb, 1989)

The expansion of assets powers for thrifts has occurred concurrently with the serious troubles now affecting the thrift industry. Two conclusions are commonly drawn from this conjunction of facts: (1) the diversification powers granted to thrifts to alleviate the maturity mismatch problems that attended concentration in mortgage financing are too risky and are responsible for the dismal performance of the thrift industry, and (2) the traditional portfolio lending activities of thrifts are safe.

No studies have been able to conclusively demonstrate that participation in non-traditional activities is related to a thrift's failure. Several studies have concluded, however, that thrifts that invested relatively more heavily in risky investments, and later failed, have been among the more costly for FSLIC to resolve. But there are many thrifts that have successfully undertaken these riskier investments. Moreover, restricting thrifts to the narrow strata of mortgage finance activities bears its own risks. It was precisely thrifts' heavy dependence on mortgage lending that made them vulnerable to the economic environment of the late 1970s and instigated the series of events that led us to the current crisis. Restricting thrifts once again to a single category of assets would potentially increase the exposure of the insurance fund to future losses by reducing opportunities for institutions to diversify their risks and thus reduce their overall portfolio risk.

According to modern portfolio theory, the overall riskiness of an institution's portfolio depends not only on the inherent riskiness of a particular asset, but upon its behavior in the context of all the assets taken together. Our work shows that well-capitalized thrifts in non-traditional activities perform comparably to well-capitalized thrifts in traditional activities, as measured by return on assets. Indeed, well capitalized thrifts tend to do well with any activities they undertake, while poorly capitalized thrifts tend to do poorly. In effect, 'well-capitalized' appears to be a reasonable proxy for 'well-managed'.

Recent studies done by the Office of the Comptroller of the Currency[3] and the General Accounting Office[4] indicate that internal problems, including management-related weaknesses, fraud, and insider abuse, are among the greatest threats to the health of thrifts and banks. If riskiness does not reside in the asset, or in the asset category per se, but rather in other factors such as management-related weaknesses, especially in response to deficiencies in the regulatory and deposit insurance system, then the optimum solution to the thrift industry problems may not involve rigid restrictions on all non-traditional activities. In fact, it may be more correct to talk about risky institutions rather than risky activities. The same activity in two different thrifts and under different institutional arrangements may be risk-reducing in one situation and risk-increasing in the other. While the problem of risky activities may be solved by prohibiting those activities, a problem of risky institutions can be solved only by regulatory and insurance reform.

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[3] See Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks, Office of the Comptroller of the Currency, June 1988.

[4] See 'Failed Financial Institutions: Reasons, Costs, Remedies and Unresolved Issues', Statement of Frederick D. Wolf before the House of Representatives, Committee on Banking, Finance and Urban Affairs, January 13, 1989.

Correcting Incentives for Excessive Risk Taking

From this perspective, the question originally posed can be more appropriately stated as "what has to be done to prevent thrifts from exposing the insurance fund to excessive risk of loss, thereby compromising the integrity of the financial system and public confidence in it?" Three major factors are involved in putting procedures and mechanisms in place to reduce incentives for thrifts to take imprudent risks, and to internalize those risks that they do take:

-- enforce levels of capital high enough to ensure that the institutions' owners bear a significant cost of failure. This means that thrifts should be closed at or before insolvency,

-- replace flat-rate deposit insurance with adjustable-rate premiums that are in proportion to the expected loss to the insurer from the institution's risk taking, and

-- strengthen the regulatory, supervisory, examination, and prosecution process sufficiently to detect and control most managerial weaknesses and fraud.

If all these factors could be effectively implemented, it would not be necessary, from the perspective of risk, to restrict depository institutions from virtually any activity. However, while the first and third modifications can and should be implemented, risk-based deposit insurance premiums are not yet feasible. The proposed risk-based capital standards, while a step in the right direction, are not a substitute for risk-based premiums.

Since it is not possible to put in place all the mechanisms necessary to control risky institutions, it may be necessary to prohibit certain activities to banks and thrifts. However, it would appear that these prohibitions could be less restrictive for well-capitalized than for low-net worth insitutions both because of the cushion provided by the institutions' own capital and because of the apparent correspondence between 'well-capitalized' and 'well-managed' institutions.

Of course, it is possible for a well-capitalized institution to incur losses. However, if such losses continue, the institution will lose its well-captialized status and its right to engage in the broader array of activities. Thus, one criterion for identifying activities that should be restricted from even well-capitalized institutions is the speed at which capital could be lost. That is, activities which expose the institution to 'explosive' losses, defined as any loss occurring too rapidly for the regulator to observe and respond, would be inappropriate for any institution.

Beyond these kinds of activities, the question becomes less one of risk than one of public policy. The choice basically depends on the larger vision of the direction that the financial services industry is taking as we head into the 1990s. It may also require a resolution of the basic incompatibility between making insured deposits available for unregulated lending and investments and promoting the goals of deposit insurance. In this regard, a deficient deposit insurance/regulatory system will accentuate this incompatibility.[5]

Resolving these broader issues will provide guidance in making decisions on the issues of the traditional separation between banking and nonbanking activities, the inequities in the current system due to mispriced deposit insurance, and the leveling of the playing field among depository institutions with increasingly similar balance sheets.

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[5] The cost of developing and maintaining an effectively functioning regulatory/deposit insurance system that minimizes the risk of loss to the insurance fund, protects the integrity of the payments mechanism, and promotes confidence in the financial system may be prohibitive. If this is so, there may very well be a basic incompatibility between making insured deposits available for unregulated lending and investments and promoting the goals of deposit insurance.

QUESTION 4:

There is a belief that savings and loan associations should devote a major proportion of their assets to residential mortgages. What percentage of their assets should thrifts devote to mortgages and mortgage-backed securities, in your judgement?

ANSWER 4:

The question of what percentage of their assets thrifts should devote to mortgage-related assets is inextricably linked to two larger issues: (1) does the housing industry require the protective mantle of the thrift industry regulatory umbrella to ensure an adequate supply of finance for the housing industry? and (2) can thrifts be viable if restricted to the mortgage lending business?

These issues are both addressed in question 2, "Do we need a separately regulated thrift industry? What is the thrift industry's role in providing financing for the nation's housing?

Limiting thrifts to a narrow strata of mortgage-related activites might jeopardize their performance and survival in a deregulated and innovative financial environment. Portfolio lending and mortgage-related activities contain risks that require skill and expertise to manage. Securitization continues to attract new participants into the mortgage finance market. This has created intense price competition and narrower mortgage yields spreads. As these trends continue, it will become more difficult for many thrifts to survive in mortgage finance activities.

The Dangers of Forced Concentration In Residential Mortgage Activities

Several developments support these conclusions and suggest that requiring thrifts to concentrate in residential mortgage-related activities might jeopardize their survival.

Inherent Weakness of Portfolio Lending

The lesson of the early 1980s is that portfolio lenders do not do well in an unpredictable and high interest rate environment. The thrift crisis of the early 1980s was triggered when serious inflation and rising interest rates exposed the inherent weakness of thrifts' reliance on long-term fixed-rate mortgages funded by short-term liabilities. Required reliance on mortgage-related assets is not a solution to this problem.

Pitfalls of Protective Measures

The maturity mismatch weakness can be overcome, to some extent, by use of adjustable rate mortgages (ARMs) and/or hedging techniques. However, ARMs provide only imperfect protection. Because many of the loans adjust annually, there may be significant lags between increases in the cost of funds and rises in mortgage yields. Also caps that lenders place on rate increases may create a binding constraint in the face of rising deposit costs.

Other protective measures including futures, options and interest rate swaps require considerable skill, as do hedging strategies involving the use of derivative mortgage securities. Difficulties and losses can develop even in the most carefully managed situations.

Thrifts with a high concentration of mortgage-related assets have outperformed the industry since 1984. However most of this period was marked by slowly decreasing or relatively stable interest rates, a favorable condition for mortgage lending. Also, the poor performance of the rest of the industry was dominated by the very dismal performance of the worst of the insolvent thrifts, whose portfolios, on average, contained a greater share of non-mortgage assets.

Securitization and Mortgage-Backed Securities

The securitization of mortgage-related assets has been the major force behind the dramatic growth in the secondary mortgage market and has dramatically affected the market for housing finance. The securitization process transforms the illiquid mortgage asset into a capital market instrument that appeals to a wide and growing range of non-thrift investors. No longer does involvement in residential mortgage loans mean involvement in all phases of the mortgage process. A mortgage asset repackaged into fragments has greater liquidity and reduced interest rate and prepayment risk. As a result, mortgage bankers, life insurance companies, pension funds, households, corporations and other insurance funds have entered the housing finance market and have become important sources of new housing credit.

With securitization, mortgages are fully integrated into the overall capital markets, and thrift institutions must compete with nontraditional investors on a secular and cyclical basis in this non-segmented market.

Securitization will continue to increase, reinforced by the presence of federal agencies, the use of new financial technology, the implementation of risk-based capital requirements with favorable risk weighting for mortgage-related securities guaranteed by U.S. Government agencies, and the use of new financial strategies, such as risk-controlled arbitrage, which involve the purchase of long-term mortgage-backed securities.

While thrifts may continue to play a central role in residential mortgage finance, they face intense competition and narrowing margins as a result of these new lenders, and only thrifts with a low cost of operations will be able to survive as portfolio holders of mortgages.

Implications and Conclusions

As portfolio lenders, thrifts no longer have a comparative advantage. Yet, thrifts continue to be central participants in all phases of housing finance, including mortgage originations and the holding of mortgage-related securities, neither of which requries the mortgage loan to be held in the thrift originator's own portfolio.

Nonetheless, the evidence indicates that within the thrift industry, there has been a significant movement away from mortgage financing activities since the early 1980s. The share of thrifts' assets devoted to mortgage activities has declined by 20 percent, and thrift holdings of total residential mortgage debt have declined by more than 15 percent.

The thrift industry is in a transitional stage. If past trends are an indication of the future, securitization will continue to increase participation in mortgage lending activities, creating more intense price competition and narrower mortgage yield spreads. This will further undermine a stable role for the thrift industry in the provision of housing finance. Thrifts that rely too heavily on mortgage lending may not continue necessarily to be the better performers.

QUESTION 5:

What is the best way to restrain state-chartered thrifts from exercising risky activities?

ANSWER 5:

GAO believes that the best way to restrain thrifts from undertaking excessively risky activities is through proper pricing of the thrift's overall level of risk. That pricing may occur as an explicit charge for risk by the deposit insurance agency, it may be an implicit charge that imposes rules and regulations that vary according to risk levels, or it may be some combination of the two. A system of risk-based deposit insurance premia, however, is not yet feasible, and risk-based capital standards, recently implemented for commercial banks and proposed for thrifts, are imperfect pricing mechanisms. Therefore, continued reliance on regulations to restrain unsafe and unsound banking practices is necessary. Such regulations must be enforced to be effective, however, and insolvent institutions must be closed.

Since 1980 the thrift industry has experienced an increased number of failures and the Federal Savings and Loan Insurance Corporation (FSLIC) has become insolvent. Much of the blame, rightly or wrongly, for this crisis has been placed on the activities into which thrifts have expanded. In particular, questions have been raised as to the types of activities that may be too risky for thrifts to engage in and how the FSLIC can control these activities, particularly when state law differs from federal law.

In the early 1980s the Bank Board indicated a reluctance to restrain state-chartered thrifts from engaging in high risk activities--generally expressing concern over states rights. GAO believes that the Bank Board had then and continues to have legal authority under the National Housing Act to promulgate regulations ensuring that all thrifts operate in a safe and sound manner. In 1985 the Bank Board reversed its opinion and announced its first regulation to control the use of direct investment powers at many state-chartered thrifts. This action was later upheld by the courts.

Beyond promulgating regulations, the Bank Board has other powers over federal and state-chartered thrifts in the form of administrative and enforcement actions. When an examination reveals violations of regulations and unsafe practices, federal officials may discuss the problems with thrift managers, send supervisory letters discussing weaknesses, or obtain written agreements with management to take corrective actions. Federal supervisors can also request the Bank Board take stronger action in the form of cease and desist orders, removal of management, and notice to terminate FSLIC insurance. The Bank Board's Office of Enforcement has indicated that there is no difference in how it responds to a district bank's request for action against either a state- or federally chartered thrift. What has been found in numerous failures, however, is a pattern of regulatory violations and unsafe practices that persisted for years after being identified by examiners, but for which the Bank Board and FSLIC failed to provide adequate follow-up.

One tactic used by the Bank Board to delay final resolution of insolvent thrifts has been to place them in the management consignment program (MCP). When this was done to a state-chartered thrift, it was first converted to a federal mutual association. This further illustrates the power that federal regulators have over state-chartered thrifts. It also makes it difficult to compare the performance of federally chartered and state-chartered thrifts over time.

Federal regulators have other avenues to control the behavior of state-chartered thrifts. For example, when insolvency or dissipation of assets occurs due to violation of the law, rules or regulations, or for any unsafe or unsound practice of a state-chartered thrift, the Bank Board may directly appoint FSLIC as a receiver. This action can take place immediately with concurrence from the state authorities or after a 90-day delay without such agreement.

To control thrift risk-taking behavior we believe that the Bank Board and FSLIC must make full use of the powers they already have--increasing their vigilance and following through on agreements to take corrective actions and on cease and desist orders. To facilitate these powers, we have recommended that procedures to revoke deposit insurance and impose sanctions on risky thrifts be streamlined. Strict closure rules should be developed and adhered to--insolvent institutions should not remain open.

To carry out the above FSLIC must be adequately funded and it should have the ability to adjust its premiums, both to control risk and to maintain its fund. FSLIC should also be separated from the Bank Board to assure its independence, and its chairperson should be appointed to a fixed term such that political pressure to forbear against risky institutions would be minimized. Other recommendations designed to enhance the ability of the insurer to protect the insurance fund are outlined in our report Troubled Financial Institutions: Solutions to the Thrift Industry Problem, GAO/GGD 89-47.

HEARING OF FEBRUARY 2, 1989

GAO's Response to Questions received from Senator Garn subsequent to GAO's February 2, 1989, testimony before the Senate Banking Committee on problems facing the Savings and Loan Industry

QUESTION 1:

In your testimony, you suggest that FSLIC promptly take control of all insolvent institutions. Isn't this suggestion similar in nature to, though much larger in size than, the management consignment plan (MCP) which was initiated by the Bank Board in April, 1985? In a GAO report (B-227753) issued in 1987, you concluded that allowing insolvent institutions in the MCP to continue to operate had a negative effect on FSLIC. Does your recommendations today represent a change in position?

ANSWER 1:

The MCP was originally intended as a short-term program to replace the management of troubled thrifts in an effort to control FSLIC's potential losses until the institutions could be sold, merged, or closed. We expressed concern about the effectiveness of the program as it was implemented because FSLIC's deteriorating financial condition did not permit the program to operate as intended. Instead the majority of MCP institutions were allowed to continue to operate with most experiencing ongoing losses. Also it isn't clear that the MCP program was designed to restrict the activities of institutions as tightly as possible. Our position is that insurance officials should promptly take control of currently insolvent institutions as it tried to do under the MCP, but this time with a clearly defined purpose of resolving the problem and enough money available to implement the program properly. The conclusion of our MCP report was that it was not possible to determine whether the thrifts losses under the MCP program were any greater than they would have been in the absence of the program.

QUESTION 2:

What would have been the up-front, cash outlay involved in liquidating all the institutions resolved in the December deals that were executed by the Bank Board? Your estimate should exclude the projected recovery on assets that would take place over time.

ANSWER 2:

FSLIC sold or merged 76 institutions in December 1988 at an estimated net present value cost of about $17 billion. FSLIC estimates that it would have cost about $23 billion (on a net present value basis) to liquidate those same institutions.

The 76 institutions held about $53 billion in deposits, thus, it would have cost nearly $53 billion in cash to pay depositors directly if the institutions had been liquidated. However, FSLIC seldom pays depositors directly. Rather, when an institution is liquidated, FSLIC most often pays depositors indirectly by providing funds through a third party in a technique called a transfer of accounts. Under a transfer of accounts, FSLIC transfers the insured deposits of the failed thrift to another insured thrift. FSLIC pays (cash, notes, assets, or a combination of the three) the acquiring institution the dollar value of the insured deposits, less a premium that the acquiring institution contributes. Thus, the amount of the cash outlay required may be lower than the actual dollar value of the insured deposits.

FSLIC may also reduce the amount of the cash outlay required in a liquidation by using a technique called an asset-backed transfer. This technique is similar to a transfer of accounts, except that FSLIC transfers the insured accounts to a newly created mutual thrift institution. To offset the liability on the new institution's balance sheet, FSLIC transfers the good assets from the failed institution and places them on the books of the new institution. FSLIC may also transfer good assets from any of its other liquidating receiverships. Thus, the asset-backed transfer allows FSLIC to do a liquidation using little or no up-front cash.

QUESTION 3:

You are critical of the fact that the Federal Home Loan Bank system technically houses the Bank Board's supervisory force. In light of the fact that the Bank Board retains control over their supervisory personnel, through the Office of Regulatory Affairs, can you give us some concrete examples of how this system has led to a conflict of interest that would have been avoided if the supervisory force had been housed directly in the Bank Board? Isn't the Bank Board's use of the bank system directly parallel to the Fed's use of their Federal Reserve Bank System for supervisory purposes?

ANSWER 3:

Although we can not cite any specific examples, our work on the causes of S&L failures shows that the current structure of the Federal Home Loan Bank System (FHLBS) is not conducive to effective oversight. The board of directors of the FHLbanks reflect a strong industry orientation. Indeed many of the directors own savings and loans. There is a fundamental conflict created by the Federal Home Loan Bank Board's (FHLBB) and district bank's roles of both promoting housing finance and regulating the thrift industry. Furthermore, the control by the Office of Regulatory Affairs over the supervisory activities of the Federal Home Loan banks is necessarily less direct than if the supervisors were Board employees. To heighten FSLIC's role of protecting the integrity of the insurance fund, we have recommended that FSLIC be made independent of the FHLBB and given adequate capability to protect its insurance interests.

Like the FHLBS, the Federal Reserve System supervises and regulates member banks. However, the Federal Reserve neither charters banks nor promotes the interests of the banking industry. Further, the Federal Reserve System does not have the added responsibility that the FHLBB has of insuring deposits at institutions that it regulates. The Federal Reserve's role as the nation's central bank and lender of last resort, and its responsibility for the financial stability of the economy are consistent with its concern for the strength and stability of the banking system.

QUESTION 4:

Within the past few years the Bank Board has taken certain regulatory actions with respect to many of the issues you discussed in your testimony. For example, the Bank Board has issued or proposed regulations to limit the growth of undercapitalized institutions, restrict direct equity investments, and impose risk-based capital requirements on thrifts. The Board has also proposed closing institutions with 1.5% capital or less. What are your views on these developments? Has the Bank Board gone far enough? What additional regulatory initiatives could the Bank Board take before we are able to pass remedial legislation?

ANSWER 4:

The Bank Board has adopted or proposed regulations that have the potential of reducing the likelihood that institutions will become insolvent. Unfortunately, it took much too long to get adequate regulations in place. Even with stronger regulations, the problems of inadequate funding and insufficient staff remain. Without an adequate source of funding and staff to shut down institutions that are presently insolvent, and take action against institutions that operate in an unsafe manner, the regulations that the Bank Board has issued or proposed cannot properly be implemented. Once the funding and personnel capability are in place, then actions that the Bank Board is currently taking, as well as other actions such as the ones we have recommended, will be more effective.

QUESTION 5:

You state that the thrift industry should pay as much as possible to resolve the FSLIC mess. Realistically, how much can we expect to get from the industry and what is the best way of getting it?

ANSWER 5:

Although we would prefer to see the thrift industry pay as much as possible to resolve the FSLIC situation, we have no basis for knowing how much higher premiums could be raised, if at all, without damaging healthy thrifts. We concluded in our report that if substantial amounts of funds were to be raised from the industry without placing one class of institutions at a competitive disadvantage, it would have to come from a broad based charge that covered all types of depository institutions.

The Administration's recent proposal for solving the FSLIC crisis obtains additional financing (about $6 billion) from the industry by tapping the earnings of the Federal Home Loan Banks. The proposal also calls for an increase in premiums for thrifts to 23 basis points per $100 of deposits from the current 20.8 basis points. The increase would be effective from January 1, 1991, to December 31, 1993, after which, the premium rate would then be lowered to 18 basis points. The net effect of this premium structure is a $1.6 billion reduction in the amount of premiums paid by thrifts between 1989 and 1999 compared to the premiums that would be collected in the same time period under current legislation.

Our report did suggest another way to achieve a modest increase in the effective industry contribution above that included in the Administration's plan. We recommended that a larger share of the money obtained from the industry over the 1989-1999 period be used to establish reserves for the insurance fund for healthy thrifts and that this contribution be accelerated. We suggested, for example, that this could be done by a capital levy on healthy thrifts of up to 1 percent of deposits. By making such a charge on healthy thrifts and by earning interest on the reserves that are built up, we calculated the contribution that would have to come from the Treasury might be reduced by about $5 billion. However, for such an arrangement to be practical, the institutions placed in the insurance fund for healthy thrifts would probably have to have levels of GAAP capital of at least 3 percent. Otherwise, the contribution to reserves could precipitate additional insolvencies.

QUESTION 6:

You state on page 3 of your prepared testimony:

> "The risks to the government inherent in insuring about $2.5 trillion in bank and thrift deposits can be very great. By far, the most serious insurance problems now are in the thrift industry."

Could you elaborate on the risks inherent in the banking industry? To what extent is the FDIC underfunded?

ANSWER 6:

While the banking industry and its insurer, FDIC, have been adversely affected by the events of the last decade, they remain fairly healthy. Downturns in certain sectors of the economy, and their resulting impact on the real estate sector, accompanied by the significant difficulties certain less developed countries (LDCs) have been experiencing in servicing their debt to many of the larger commercial banks, have had the most significant effect on the banking industry.

While the problems LDCs are having in servicing their debt have not been solved, banks have taken actions to minimize the impact of these problems. Since 1982, U.S. banks in general have curtailed new loans to LDCs and increased their capital and loan loss allowances, while some banks have substantially eliminated LDC loans from their portfolios. At the same time, some further losses and write downs of this debt will likely be incurred and could place a strain on banks holding a significant amount of LDC debt. Therefore, while the potential impact of the LDC debt problem on FDIC has been reduced, it is still an area that must be monitored.

Preliminary results of our audit of FDIC's 1988 financial statements show that FDIC incurred its first loss since its inception--$4.2 billion. This loss was primarily due to the $7.3 billion cost associated with 1988 failure and assistance transactions, including over $3.0 billion for the failed First RepublicBank Corporation of Dallas, Texas; and to $2.8 billion set aside for several probable but unexecuted assistance transactions, primarily in the Southwest.

FDIC's $4.2 billion net loss reduced its insurance fund balance to $14.1 billion as of December 31, 1988. As a result, the ratio of the insurance fund balance to insured deposits declined to its lowest level ever, estimated to be .83 percent. FDIC has already assisted or set aside funds for all of the large problem banks in the Southwest; and it does not have a significant exposure related to insolvent or barely solvent banks. While we believe that FDIC's resources are adequate to handle current and near-term identifiable needs, as a result of the decline in FDIC's insurance fund balance, we believe that it is imperative to take steps to increase FDIC's insurance fund to an adequate level. As evidenced by the S&L industry's and FSLIC's problems, delaying action to increase FDIC's insurance fund could be costly.

QUESTION 7:

The Bank Board has recently proposed a risk-based capital regulation that would vary minimum required capital levels based on both the credit risk and interest rate risk of a thrift institution's portfolio. Certain assets would require no capital cushion, such as cash or short-term government securities, while other assets would require as much as 18 percent capital, such as direct real estate investments or equity investments. However, even if an institution invested all of its assets in risk-free instruments, it would still be required to maintain a flat 2 percent minimum ratio of capital to total assets. This proposal would be phased-in over several years, would require institutions to increase their capital substantially (or restructure their assets substantially), and is generally regarded as a tough standard. What is your view of the proposal?

ANSWER 7:

We view the proposal as a positive development to achieving the goal of comparable financial responsibility standards for banks and thrifts. We also believe having both a risk-based component and an overall capital component is the right approach. However, we have several concerns. We see significant differences between the Bank Board's proposal and the capital standards being implemented by bank regulators. Specifically, we are concerned that the Bank Board's gradual approach to raising the overall capital standard for thrifts moves too slowly to achieve a relatively lower standard--a difference which is enhanced by the Bank Board's more liberal treatment of items such as goodwill. We also believe the 2 percent minimum ratio of capital to assets is itself too low a standard. Furthermore, we are concerned that the increased use of forbearance, particularly with respect to institutions created by the FSLIC deals, has created a sizable category of institutions which can operate with even lower requirements than those imposed on the majority of thrifts.

QUESTION 8:

Like others, you have criticized the Southwest Plan transactions for resulting in thrifts with too little capital in proportion to total assets. (One figure puts the average at between 2 and 3 percent.) FSLIC's response is based on the risk-based capital proposal described above. Its argument is that most of the assets in a newly-acquired Southwest Plan thrifts are a combination of FSLIC notes and FSLIC-guaranteed assets, both of which, in effect, have short-term interest rates. FSLIC assumes that the government will make good on these commitments, and as a result, they are risk-free assets for the new institution, like cash or U.S. Treasury securities. As such, they require no capital cushion under the Bank Board's new risk-based capital regulatory scheme. The institution must still contribute substantial capital to support the risky assets in its portfolio, and must still meet an overall requirement of two percent capital to total assets even if it is entirely invested in risk-free assets. In addition, any new assets would have to be supported by capital according to the risk-based scheme. According to the Bank Board, virtually all of the new Southwest plan thrifts satisfy the new risk-based capital minimum requirements, with high capital levels in relation to the assets that are actually risky. In short, while the capital-to-total-asset ratio is typically low, the capital-to-risky-asset ratio is typically quite high, and therefore the "moral hazard" to take excessive risks because of low capital levels is simply not present. What is your response?

ANSWER 8:

We believe "moral hazard" is still present to a substantial degree in the Southwest Plan transactions. Moral hazard is the incentive for the owners of the institution to impose risks on the insurance fund because they have little capital of their own at risk. We estimate that in 9 of 12 Southwest plan transactions we examined, investors can recover their capital investment through tax breaks alone within an average of 3 years. In other words, the potential real net loss to the investor, while not very large to begin with, declines quickly. Furthermore, the plan calls for the institutions to recover largely on the basis of internally-generated earnings, a major portion of which comes from FSLIC-guaranteed covered assets. If the institutions finance nearly all of their recovery using the earnings on these covered assets or by borrowing against these FSLIC-guaranteed assets, the owners will continue to have little of their own capital at risk. The forbearance provisions included in the deals can also affect the owners' incentives to the extent they permit owners to make loans and investments not otherwise permitted for thrifts who do not meet regular capital standards. We recognize that in most, but not all, of the assisted transactions, the capital forbearances are linked to assets and liabilities of the acquired institutions. Depending on the investments assisted institutions are permitted to make, the insurance fund could continue to be exposed to considerable risk.

HEARING OF FEBRUARY 2, 1989

GAO's Response to Questions received from Senator Sasser subsequent to GAO's February 2, 1989, testimony before the Senate Banking Committee on problems facing the Savings and Loan Industry.

QUESTION 1:

Mr. Bowsher you are proposing that the FSLIC be split off from the Bank Board as the FDIC is separate from the Comptroller of the Currency. I think there's a decent argument for that.

But on P.4 of your statement you say that "the industry itself is overseen and supervised by the Federal Home Loan District Banks, which, in turn, are owned by each District Bank's constituent institutions." Now these district banks are also affiliated with the Bank Board, unlike the Federal Reserve Banks and the Comptroller of the Currency. Is the affiliation of the District Banks with the Federal Home Loan Bank Board a problem too? Should they be split off? What about the District banks supervising the thrifts that own the district banks? The Federal Reserve banks don't supervise commercial banks? Isn't this a conflict?

ANSWER 1

Although we cannot cite any specific examples, our work on the causes of S&L failures shows that the current structure of the Federal Home Loan Bank System (FHLBS) is not conducive to effective oversight. The board of directors of the FHLbanks reflect a strong industry orientation. There is a fundamental conflict created by the Federal Home Loan Bank Board's (FHLBB) and district bank's roles of both promoting housing finance and regulating the thrift industry. Furthermore, the control by the Office of Regulatory Affairs over the supervisory activities of the Federal Home Loan banks is necessarily less direct than if the supervisors were Board employees. To heighten FSLIC's role of protecting the integrity of the insurance fund, we have recommended that FSLIC be made independent of the FHLBB and given adequate supervisory capability.

Like the FHLBS, the Federal Reserve System supervises and regulates member banks. However, the Federal Reserve neither charters banks nor promotes the interests of the banking industry. Further, the Federal Reserve System does not have the added responsibility that the FHLBB has of insuring deposits at institutions that it regulates. The Federal Reserve's role as the nation's central bank and lender of last resort, and its responsibility for the financial stability of the economy are consistent with its concern for the strength and stability of the banking system.

QUESTION 2:

Mr. Bowsher, you say that the thrift industry should pay for as much of the funding shortfall as possible. I agree with that. You go on to say that the bulk of the money will have to be found elsewhere, because the thrifts basically don't have the kind of money we're talking about.

I am curious about your statement "if contributions are not sought from other segments of the depository institutions industry, then the shortfall will have to be met by the federal government."

What do you mean by that last statement? What other segments of the depository institutions industry are you talking about? What kind of contributions?

ANSWER 2:

Although we would prefer to see the thrift industry pay as much as possible to resolve the FSLIC situation, we have no basis for knowing how much higher premiums could be raised, if at all, without damaging healthy thrifts. In our opinion, a contribution from the banking industry (in the form of an increased insurance premium) should be considered because the banking industry stands to benefit from the clean-up of the thrift problem. We concluded in our report that if substantial amounts of funds were to be raised from the industry without placing one class of institutions at a competitive disadvantage, it would have to come from a broad based charge that covered all types of depository institutions.

The Administration's recent proposal for solving the FSLIC crisis obtains additional financing (about $6 billion) from the industry by tapping the earnings of the Federal Home Loan Banks. The proposal calls for an increase in premiums for thrifts to 23 basis points per $100 of deposits from the current 20.8 basis points. The increase would be effective from January 1, 1991, to December 31, 1993, after which, the premium rate would then be lowered to 18 basis points. The net effect of this premium structure is a $1.6 billion reduction in the amount of premiums paid by thrifts between 1989 and 1999 compared to the premiums that would be collected in the same time period under current legislation.

Our report did suggest another way to achieve a modest increase in the effective industry contribution above that included in the Administration's plan. We recommended that a larger share of the money obtained from the industry over the 1989-1999 period be used to establish reserves for the insurance fund for healthy thrifts and that this contribution be accelerated. We suggested, for example, that this could be done by a capital levy on healthy thrifts of up to 1 percent of deposits. By making such a charge on healthy thrifts and by earning interest on the reserves that are built up, we calculated the contribution that would have to come from the Treasury might be reduced by about $5 billion. However, for such an arrangement to be practical, the institutions placed in the insurance fund for healthy thrifts would probably have to have levels of GAAP capital of at least 3 percent. Otherwise, the contribution to reserves could precipitate additional insolvencies.

QUESTION 3:

McKinsey and company testified in the committee the other day and indicated that acquisitions of failed thrifts under the so-called Southwest Plan will cost the federal government more, in net present value terms, than outright liquidations.

What is the GAO's view of this? Does the Bank Board calculate the cost to the treasury and the taxpayer of the tax benefits, when it calculates the cost of an acquisition?

Under the Garn-St. Germain Act, the Bank Board can do an acquisition instead of a liquidation only if the acquisition is cheaper than a liquidation, is the Bank Board violating the law?

Can you estimate the cost of the tax benefits to the treasury? The tax law was changed at the end of 1988 to diminish the impact of these provisions -- will this slow down the amount of federal dollars that are being spent this way?

ANSWER 3:

In 1988, FSLIC sold or merged 179 institutions at an estimated net present value cost of about $38 billion. FSLIC merged 87 institutions under the Southwest Plan, at an estimated cost of about $25 billion in net present value terms. FSLIC estimated that it would have cost about $29 billion (net present value) to liquidate these same institutions.

With little cash, and without accurate information about the real financial condition of the thrifts, the FHLBB provided a wide range of financial assistance to attract acquirers to buy packages of thrifts. Acquirers who purchased the packages of failed thrifts were given 10-year notes, asset value guarantees, yield coverage, reimbursement for certain expenses, extensive tax benefits, and forbearance from certain regulations. The cost of this assistance could be more than FSLIC has estimated, and could even be more than the original estimated cost of liquidating the thrifts if (1) the assets for which FSLIC provides an operating subsidy have lesser value than unaudited financial reports indicate, requiring increases in FSLIC subsidies, or (2) interest rates increase, making it difficult for thrifts to realize projected income levels and increasing the amount of FSLIC assistance needed.

Another factor which could influence the cost of FSLIC's transactions is the estimated tax benefits. Our estimate of the tax benefits for FSLIC's 1988 transactions is between $7 billion and $8 billion in present value terms. FSLIC did not adequately take these tax benefits into account when negotiating the merger agreements. In deciding whether merger or liquidation was least costly, FSLIC was not legally required to consider the cost of the tax benefits. But our analysis of the 1988 merger deals to resolve failed thrifts suggests that, if the full cost of the deals to the Government is considered, liquidation would have been cheaper in as many as a third of the 12 transactions we reviewed.

QUESTION 4:

McKinsey and company also called the Southwest Plan socially unfair because it provides already rich entrepreneurs and financiers with a largely risk-free opportunity to become richer. All these deals are tax driven. To take advantage of them, you have to have a lot of income that you want to shelter. McKinsey said the government is playing Robin Hood in reverse -- do you agree?

ANSWER 4:

We agree that FSLIC's practice of using tax benefits as the primary incentive for attracting buyers for insolvent thrifts raises equity concerns. Because the revenue loss to the government was not a cost that FSLIC factored into its bid evaluation process, bidders who placed a high value on the tax benefits would have the advantage of being able to structure their bids so that they required fewer direct payments from FSLIC. Since FSLIC had little money to make such direct payments, bidders who could accept tax benefits obviously had an advantage over other bidders.

QUESTION 5:

Mr. Bowsher, Chairman Seidman (Seedman) of the FDIC has been critical of the way of federal budget process affects the FDIC and the FSLIC. He thinks it creates a perverse incentive. In other words, regulators may shy away from liquidating an institution, which would involve a relatively large outlay, because of the impact it will have on federal spending and the deficit. This is troubling because in many cases liquidations save the insurance fund money in the long run. What do you think?

The on-budget nature of deposit insurance funding does potentially create an incentive to minimize fund outlays so as to avoid increasing the Federal deficit. However, we believe it is advantageous to fully reflect the cost of deposit insurance in the budget so that the budget provides a complete picture of the government's financial condition. Moreover, an off-budget approach also carries some cost to the government since any borrowing by an off-budget entity will be at rates higher than Treasury rates. We therefore recommend that an on-budget approach be used in a thrift rescue plan, even if it requires revising the Gramm-Rudman-Hollings deficit targets. We also think that a restructured federal budget along the lines we have proposed elsewhere would better highlight the financing of FSLIC and similar enterprises set up to operate on a business-like basis. (See Financial Management Issues, GAO/OCG-89-7TR, November, 1988.)

QUESTION 6:

Mr. Bowsher, it is my understanding that the GAO has examined some 27 insolvent savings and loans and found fraud in every one. What percentage of the loan portfolios of these S&Ls involve fraudulent loans? What kind fraud is it -- inflated appraisals for loans -- or is it worse?

ANSWER 6:

We recently completed a review of examination reports and other regulatory records involving 26 failed thrifts which have caused some of FSLIC's larger losses. These records showed the presence of "fraud and other insider abuse" as broadly defined by the Bank Board at each of the failed institutions in our sample. The results of this assignment are summarized in Assistant Comptroller General Frederick Wolf's March 22, 1989 testimony before the Subcommittee on Criminal Justice, Committee on the Judiciary, a copy of which is enclosed for your information. As discussed in the testimony, the problems reported by examiners involved not only various aspects of the lending process, but also other key management functions.

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United States
General Accounting Office
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General Government Division

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The Honorable Bob Graham
United States Senate

Dear Senator Graham:

This letter is in response to your request that we review and comment on two bills, S.287, which separates the Federal Savings and Loan Insurance Corporation (FSLIC) from the Federal Home Loan Bank Board (FHLBB), and S.288, which gives FSLIC the authority to allow risk-based insurance premiums. You also requested that we provide suggestions for regulatory changes that should be incorporated into legislation, and examine the question of whether FSLIC can intervene with a savings and loan that has not been found to be insolvent.

We generally support the spirit of both S.287 and S.288, however, we believe that deposit insurance reforms should be part of a comprehensive plan to provide adequate funding for current and future losses in the system. Although the major problems in the deposit insurance system are concentrated in FSLIC, we have some concerns about the Federal Deposit Insurance Corporation (FDIC) as well. As such, we strongly urge that reforms which strengthen the authority of the insurer be extended to FDIC.

S.287

The substance of S.287 is consistent with the recommendation in our enclosed report, Troubled Financial Institutions: Solutions to the Thrift Industry Problem,[1] that FSLIC be disengaged from the FHLBB. The Bush Administration has also proposed a bill (S.413) that, among other things, calls for the separation of the insurance function from the FHLBB. We believe that an independent insurer is a worthy goal. Nevertheless, there are several points that should be clarified to enhance the effectiveness of S.287.

Section 2 of S.287 would provide FSLIC's Board of Trustees with a chairman and two members, appointed by the President with the advice and consent of the Senate. In our report, as well as in our testimony before various congressional committees, we have strongly supported an independent FSLIC, with an organizational structure similar to the FDIC model.

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[1] GAO/GGD-89-47, February 21, 1989.

One aspect of FDIC's structure that we strongly support is the fixed term for the members of FDIC's Board of Directors. We have also supported such a fixed term for the Board Chairman. We believe that fixed terms serve the interests of continuity of service, as well as the desire to insulate members from undue political pressure.

The bill does not indicate whether the examination function shall be transferred to the independent FSLIC from the Federal Home Loan Banks. We think it necessary that FSLIC have some means to independently review the condition of the institutions whose deposits it insures to adequately protect the integrity of the insurance funds it administers. The current structure of the Federal Home Loan Bank System (FHLBS) is not conducive to effective oversight. There is a fundamental conflict created by the FHLBS' and the district banks' roles of both promoting and regulating the industry.

Similarly, the bill does not specify whether functions such as closing institutions, approving entry of most new members to the system, and enforcement of regulations or supervisory actions will explicitly transfer to FSLIC or remain with the FHLBB or Federal Home Loan Banks. One way to ensure that an independent FSLIC better protects the insurance fund is to enable it to take firm action against institutions that expose the insurance fund to a material level of risk. In our report, we recommended that both FSLIC and FDIC be given authority to place stringent controls on improperly operated and/or undercapitalized institutions and to expeditiously withdraw insurance from such institutions.

We also recommended that (1) both FSLIC and FDIC be given the authority to raise assessments as needed to meet future insurance costs, and (2) consistency in regulation and supervision of banks and thrifts be established in matters that have a material effect on the government's exposure to deposit insurance losses. These recommendations, together with providing an independent FSLIC with adequate supervisory resources would further strengthen S.287.

S.288

As noted above, S.288 would give FSLIC the authority to provide for risk-based deposit insurance premiums. Although we generally support the idea that risks to the insurance funds be properly priced, there are significant problems associated with setting deposit insurance premiums that reflect the expected loss to the insurer. These problems would make implementing S. 288 difficult. For example, implementing risk-based premiums would require FSLIC to do things that are likely to prove politically difficult, such as sending out notices of huge insurance premium increases to institutions that have been weakened by the realization of losses from risk taking. (See appendix IV of our report for a detailed discussion of risk-based premiums.)

While a risk-based premium and other approaches that would significantly change the way risks are priced merit consideration, we believe Congress should proceed with caution in this regard. We believe that it is more appropriate to first take steps to reform the deposit insurance system within its existing concept. Experimenting with changes in the way in which risks are priced could occur later.

OTHER ISSUES

You requested that we examine whether FSLIC may intervene with a savings and loan for grounds other than insolvency. FSLIC may be appointed conservator or receiver of both state and federally-chartered savings and loans under several circumstances not involving insolvency.[2] These include instances of dissipation of assets and earnings due to legal or regulatory violations, an unsound business condition of the thrift, or failure to comply with cease and desist orders or requests for information. (See enclosure II for a more detailed discussion of the conditions under which FSLIC may intervene with a thrift and the applicable statutory provisions.) However, the FHLBB must approve any takeover of a troubled thrift by FSLIC. Thus, although FSLIC may intervene with a savings and loan when conditions other than insolvency exist, under the current structure, FSLIC may exercise its legal authority to take action against any thrift only through the FHLBB.

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[2] The FHLBB must obtain agreement in writing from state regulators that conditions exist which warrant appointment of FSLIC as conservator or receiver. If the FHLBB does not receive such concurrence within 90 days it may appoint FSLIC without state approval.

FSLIC's inability to act independently of the FHLBB to curtail the activities of a thrift whose operations pose significant risk to the fund is another example of the need to establish an independent insurer for the thrift industry. With sufficient powers to protect the fund - and with adequate resources to accomplish this - an independent FSLIC would be in a much better position than FSLIC is now in to impose discipline in the thrift industry and to assure implementation and enforcement of actions that have a material effect on deposit insurance finances.

Finally, we made a number of recommendations on reforming the deposit insurance system in our report that Congress should consider incorporating in legislation. See enclosure I for a detailed list of our recommendations.

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Should you have any further questions or need additional information please feel free to contact Craig A. Simmons on 275-8678.

Sincerely yours,

J. C. Finch
for
Richard L. Fogel
Assistant Comptroller General

Enclosures

Enclosure I

GAO RECOMMENDATIONS FOR REFORMING THE DEPOSIT INSURANCE SYSTEM

The following is a list of the recommendations GAO has made to reform and protect the integrity of the deposit insurance system. See chapter 5 (Risk Management and Deposit Insurance Reform) of our report for a detailed discussion of these recommendations.

-- Disengage FSLIC from the Federal Home Loan Bank Board and create an independent insurance function for the thrift industry that has adequate supervisory resources.

-- Enhance the ability of both an independent FSLIC and FDIC to place stringent controls on improperly operated and/or undercapitalized institutions and to withdraw insurance from such institutions.

-- Provide FDIC and FSLIC with the authority to raise assessments as needed to be able to meet future insurance costs, over and above whatever special arrangements are worked out for solving FSLIC's current crisis.

-- Direct the appropriate agencies to establish consistency in regulation and supervision of banks and thrifts in matters that have a material effect on the government's exposure to deposit insurance losses.

-- Strengthen capital adequacy requirements and their enforcement.

-- In consultation with federal and state chartering agencies, pursue a more comprehensive reform agenda after FSLIC's funding needs are met and other recommendations implemented. This agenda should permit some experimentation so that all institutions will not necessarily have to fit into the same approach. For example, institutions could be offered a choice of whether they wanted to collateralize deposits or place their insured deposits in a narrow bank in return for lower premiums or enhanced powers.

Enclosure II

CONDITIONS UNDER WHICH FSLIC MAY INTERVENE WITH A SAVINGS AND LOAN

A series of provisions within the National Housing Act (12 U.S.C. sec. 1724 et seq.) and the Home Owners' Loan Act (12 U.S.C. sec. 1461 et seq.) enable FSLIC to intervene in the operations of both federally and state-chartered thrifts.

In the event that a federal savings and loan association is in default, the Federal Savings and Loan Insurance Corporation (FSLIC) must be appointed as its conservator or receiver. 12 U.S.C. sec. 1729(b). The Home Owners' Loan Act, at 12 U.S.C. sec. 1464(d)(6)(A) provides that:

> "The grounds for the appointment of a conservator or receiver for [a federal] association shall be one or more of the following: (i) insolvency in that the assets of the association are less that its obligations to its creditors and others, including its members; (ii) substantial dissipation of assets or earnings due to any violation or violations of law, rules, or regulations, or to any unsafe or unsound practice or practices; (iii) an unsafe or unsound condition to transact business; (iv) willful violation of a cease-and-desist order which has become final; (v) concealment of books, papers, records, or assets of the association or refusal to submit books, papers, records, or affairs of the association for inspection to any examiner or to any lawful agent of the Board."

Appointment of FSLIC is within the exclusive jurisdiction of the Federal Home Loan Bank Board (FHLBB). If, in the opinion of the FHLBB, a ground for appointment of a conservator or receiver exists, it may appoint FSLIC ex parte and without notice. Id.

When an insured institution other than a federal association is in default, FSLIC has the authority to act as conservator or receiver and its services are tendered to the court or other public authority having the power of appointment. Notwithstanding the above, the FHLBB has exclusive power and jurisdiction to appoint FSLIC conservator or receiver of such an insured institution upon a finding that any of the grounds specified at 12 U.S.C. sec. 1464(d)(6)(A)(i), (ii), or (iii) (as set out above) exist.

Regardless of the manner in which FSLIC is appointed receiver, it is authorized under 12 U.S.C. sec. 1729(b)(1)(A):

> "(i) to take over the assets of and operate such association;

"(ii) to take such action as may be necessary to put it in a sound solvent condition;

"(iii) to merge it with another insured institution;

"(iv) to organize a new federal association to take over its assets;

(v) to make such other disposition of the matter as it deems appropriate;

whichever it deems to be in the best interest of the association, its savers and the corporation."

PROBLEMS OF THE FEDERAL SAVINGS AND LOAN CORPORATION [FSLIC]

PART I OF IV

TUESDAY, FEBRUARY 7, 1989

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Cranston, Sarbanes, Dodd, Dixon, Sasser, Sanford, Shelby, Graham, Wirth, Kerry, Bryan, Garn, Heinz, D'Amato, Gramm, Bond, Mack, Kassebaum, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The Chairman. The committee will come to order.

We want to welcome our witness today. I will start by making a few initial comments and then yielding to my colleagues who also will have an opportunity to do the same.

I think there will be observations that members want to make in light of the presentation yesterday of the general outline of the administration's proposal for dealing with the savings and loan and FSLIC problem. So, after I have made my comments, I will yield to my colleagues, and, then, we will introduce our very distinguished witness today.

First of all, I think the President deserves to be commended for moving quickly with his proposal for dealing with the savings and loan and FSLIC problem. We have seen the general outlines of the proposal. We have received some briefings on it. We do not yet have detailed materials in writing. It will take a few days before those are ready. We will be very anxious to see the precise details, and I would hope that we can talk back and forth with the administration on the development of the fine print on this before the proposal actually comes down to us.

When it does come, it will be my intention to introduce that legislation along with the ranking minority member so that it is formally presented to the Senate. We will continue to keep the track clear in the Senate Banking Committee to deal solely with this issue until we have handled it and reported out to the Senate.

I think that on the reform side of the package there are a number of very constructive steps that are included. I think there are a couple major unresolved issues that need our attention.

One is making sure that we address the issue of what are federally chartered and granted operating authorities for savings and loans upon which we then will provide the Federal deposit insurance guarantees and how do we square that with States in the past and the present that have gone way beyond that in offering additional powers, many of which carry a much higher risk profile. I think these powers have to be lined up. I've said that repeatedly. I know Senator Garn has said the same thing, but I think we really have to nail that issue down.

Second, it's very important to make clear what the operating charter of the savings and loan will be for the future. Although I start with the presumption that it will center around the home mortgage function, which is the principal purpose of the savings and loan industry and a very important one for the country, any additional activities must constitute a prudent and balanced set of operating authorities for federally insured thrifts. I think this has to be very clearly set forward.

On the funding side, the funding plan is complicated. While it looks in large measure to the industry as well as the commercial banking industry for increases in insurance fees to help provide some of the wherewithal to deal with this problem, there is still a very substantial impact is borne by the general government or all of us as citizens.

There is a question of how much premium cost may be involved in using an arm's length financing mechanism rather than actually directly issuing Treasury bonds. I've heard different estimates as to what that premium cost is by year or over the 30-year period of the bonds, but I think we've also have to weigh the implications of how much premium cost it makes sense to incur in order to go through a very complex accounting exercise.

I also want to emphasize today the issue of how the Gramm-Rudman-Hollings constraints affect this problem because if we absorb part of this cost, at least the interest cost on the bonds that have been proposed within the formal budget structure, then presumably that money has to come from something else. And that raises the question, does this mean that it comes from Medicare or education or the defense budget or from the drug fight or what have you. When you get into the area of hundreds of millions and then billions of dollars annually, it's a very material consideration.

There are estimates from the administration that indicate that the first year impact is something like $1.9 billion that comes straight through. The second year impact is roughly $6 billion. If we're going to accommodate that, then something else is going to have to shrink in the process and that's a very difficult issue and something that has to be gotten out into the open and considered with care.

Finally, just let me say two other things. I am determined to see us not only work quickly on the committee to match the speed with which the administration has moved but to do so on a fully bipartisan or nonpartisan basis. I think we can produce a legislative package here as soon as we've had a chance to complete our hearing process and to get the detailed proposals from the administration, which they will have for us I hope within a week or two, and then move into a markup situation.

I want to make sure, as well, that anybody else who has a point of view that they want to represent has a chance to get that information to the committee, that we consider it, and that we make it part of our committee record.

So with that, I will reserve my introductory remarks for Mr. Volcker and yield to Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator **GARN**. Thank you very much, Mr. Chairman.

Chairman Volcker, we are happy to welcome you back to the committee. I made a private comment to you as you walked by that we have missed you. You probably have not missed us and that's understandable, but you do have the opportunity as a matter of chance to be the first witness to comment publicly on the administration's new thrift plan and we look forward to that.

Let me just make a few general comments. I believe the administration's new thrift proposal is an excellent first step toward resolving the thrift crisis. It certainly is not perfect and I have a few reservations about certain of its aspects, as I'm sure some of my colleagues do. But its overall concept, in my opinion, is the right one.

The chairman started hearings a week or so ago. We were united—at least he and I and I think most of the committee—on suggesting that this could not be a short-term bailout plan, just putting out money to do something quickly. We felt very strongly that we have to obviously raise more money but, in addition, we need some structural reform, some real changes in the regulatory system, in the deposit insurance system, and in thrift industry regulation.

The administration has certainly touched all of those in a very comprehensive way because it wouldn't make any sense to solve the immediate crisis of the 350 thrifts and not recapitalize the insurance funds for the future—to make sure that some future committee doesn't go through the same situation.

I have heard a number of positive comments about the plan from some of my colleagues and even from some in the industry. This means I believe the plan is generally workable. It also means that in Congress we have a sound basis to move extremely quickly to make our changes and to enact legislation. We need to do this just as soon as possible to stop the bleeding. More delay means losses mounting into the billions and Congress has already caused enough problems through delay over the last 3 years.

I certainly wish to applaud and congratulate Chairman Riegle for getting a head start with these hearings even before the administration introduced their concept of how to solve this problem and I certainly echo his words that this problem is serious enough that we don't have time to be partisan about it. It is not a Republican or a Democratic problem. Certainly that has been the case so far in our relationship with him as new chairman. It's been a very good working relationship between Don and I, and I do expect that certainly within the next couple of months, I would hope not much longer than that, we are able to get together—and not just us, but the entire Congress and the administration—to pass legislation. And certainly he will have my help to do that.

I will save my specific comments about the proposal until we see more details and get them all up here in writing, but I would like to make one further observation.

During the last year the Federal Home Loan Bank Board has suffered a great deal of criticism but has also proposed or put into place some key regulatory initiatives that are geared to the particular business or thrift institutions. These include risk-based capital standards that are keyed to interest rate risk, an early closure proposal and rules to monitor complex hedging practices. The rules are tough, are tailored to thrifts, and I'm concerned that in the rush to embrace bank regulatory practices that these will get thrown by the wayside. We do need to restructure the regulation of the thrift industry, but we ought to make sure that we preserve the best work that has been done over the last several months and years.

The Bank Board has built an excellent regulatory staff and we need to be careful to enhance that staff in these changes and not weaken it as this process moves forward.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. And thank you for your very kind personal comments.

Senator Cranston.

OPENING STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. Thank you, Mr. Chairman.

Paul, I just want to welcome you once again before this committee. We need your advice as never before. We've never had a problem of these dimensions before us and before the country.

I just wanted to say that I hope in your opening remarks whatever you planned to say you can comment on the administration's proposal because that will be the takeoff point for our considerations and whatever light you can shed from your vantage point on what they have proposed would be very, very helpful to us right now.

[The complete prepared statement of Senator Cranston follows:]

PREPARED STATEMENT OF SENATOR ALAN CRANSTON

Mr. Chairman, I would like to welcome Mr. Volcker on his first visit before the Banking Committee as a private citizen.

As we consider the need to adequately recapitalize FSLIC and grapple with the very difficult task of assuring ourselves and the American taxpayer that the thrift problems will not occur again or spread to the banking industry, there can be no doubt the solution will cost a great deal of money and that broad financial reform is also forthcoming on the horizon.

In many respects, the very nature of today's FSLIC crisis is but a microcosm of systemic problems facing our entire financial sector. The financial services industry continues to labor under the inefficiencies of a regulatory system enacted over 50 years ago. That system was designed to restrict competition among various sectors of the industry in the belief that compartmentalization of products and services would enhance the overall safety of these institutions dollars.

This situation would be merely unsatisfactory if our country's financial system could somehow exist in a vacuum. However, it is made all the more alarming by the fact that financial markets are global in nature and irrevocably linked. Moreover, there are important changes on the horizon in international markets that will sharply alter the worldwide competitive environment in the financial services industry in 1992.

We in Congress have an immediate obligation to act immediately to resolve the thrift crisis in a manner that is not only satisfactory but in a manner that does not destroy the ability of our financial system to remain competitively viable.

Senator D'Amato and I will be reintroducing our bill the Depository Institutions Affiliation Act in the very near future which we think will accomplish true comprehensive reform with safeguards for the future.

I realize that our immediate attentions will of necessity, be occupied by the thrift industry and the deposit insurance crisis. But as Congress grapples with them, we would do well to ask ourselves what kind of overall regulatory structure could be implemented which at the same time, makes us well equipped to compete in the dynamic, global marketplace of the future.

The Treasury proposal on the thrift crisis certainly starts us down the road of massive restructuring of the financial services industry.

I look forward to hearing from the witness this morning.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Thank you, Mr. Chairman.

I just want to welcome Paul Volcker back to this committee. He's been before us many, many times. He has always contributed mightily and, Paul, thank you for coming back again on this. This may make LDC debt look easy.

I might just say as to the administration's proposal which was outlined, it is less taxing than the proposal that was leaked a week ago, but it does prove, in my judgment, that when you're constructing a legislative blueprint under these circumstances that producing such a blueprint is extremely difficult when the pen you've got to work with is overflowing with red ink.

On balance, I think the administration has given us a very credible plan. I'm sure there are elements of it that we will all want to look at carefully, but it seems to me that it meets the basic tasks we need to meet to get our house in order.

The first one is to fill that multibillion hole caused by the record losses in the thrift industry.

The second is to cement a framework down on a bedrock of private capital so that Federal deposit insurance fund is cushioned from the economic tremors that can occur from time to time. That private capital provides stability so that when problem in financial institutions flare up we don't let them burn without having a fire extinguisher ready.

We have certainly learned, if nothing else, we can't afford to let it burn policy and in my judgment unless we raise insurance premiums the taxpayer is bound to get burned.

I think we all agree that the framework has to be sturdy enough to maintain the confidence of those who entrust their savings to depository institutions and it would appear that the administration's policy does that.

Finally, and I think this echoes a point, Paul, that you have in your testimony, we want at the same time as we build a fortress that is both sound and secure for the depositors' money we also want to be sure that the American home buyer isn't locked outside. We want to maintain a viable retail mortgage credit industry and most of us I think believe that it's important to solve the problem in a way that doesn't kill the patient.

Paul, we welcome you here. We look forward to your commentary.

The CHAIRMAN. Senator Bryan.

Senator BRYAN. Thank you very much, Mr. Chairman.

Like my other colleagues, I, too, look forward to hearing your comments this morning and particularly with reference to the administration's proposal.

Mr. Chairman, if there's no objection, in the interest of time, I'd like to ask that my opening statement be included and incorporated as part of the record.

The CHAIRMAN. Without objection. Thank you.

OPENING STATEMENT OF SENATOR RICHARD BRYAN

Senator BRYAN. Mr. Chairman, I welcome the opportunity to hear the testimony of the former Federal Reserve Chairman and hope that private life is treating you well.

I would also like to commend President Bush for the prompt manner in which he has tackled this critical problem with our savings and loan industry. I believe this bodes well for the new administration that it is willing to step up to the plate and tackle the difficult problems facing our Nation in a timely manner. I hope that this attitude will continue as we face the nuclear waste and Federal deficit problems.

I have not had an opportunity to study the intimate details of the President's proposal but, I am gratified to see that the proposal provides for comprehensive structural reforms to insure this problem doesn't reoccur. While I believe swift action is imperative, I would oppose legislation which dealt with the financial part of the problem without putting into place the necessary structural changes in the regulatory system.

I further commend the administration for moving quickly to shut down bankrupt S&L's. I believe this approach is far superior to the slipshod, inefficient deals worked out during the waning hours of last year.

I look forward to working with my colleagues to craft a plan that incorporates many of the administration's suggestions in a timely fashion. I would hope we could have a bill on the President's desk after expeditious, but careful consideration.

I look forward to hearing Mr. Volcker's comments.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, I, like others, am anxious to hear Mr. Volcker's response to President Bush's plan for funding the FSLIC deficit and reforming the deposit insurance system, and I am particularly pleased to note that Chairman Volcker, notwithstanding his expertise, is perhaps the first witness ever to appear before this committee who did not claim to know how much the problem is going to cost. I think such humility should not go unrecognized.

Mr. Chairman, let me just comment on one aspect of the proposal that's put forth and that is that part of the plan which recognizes the importance of finding and prosecuting the people who squandered Federal insurance deposits, those few who looted the banks, with greedy and unscrupulous operations, and I believe that the request for additional funds for the U.S. attorney's office is a very good investment because I wholeheartedly support the pursuing of those who have looted these banks and bringing them to justice and, in addition, that portion of the plan to increase sentences and fines and impose minimum sentences to the authority and to also authorize the system of payment of bounty. I think that's important. I think that there's moneys that we can collect and I think that the unscrupulous operators should be prosecuted to the fullest extent of the law. I can tell you that constituents that I've run into at home have continually brought this forth as a source of great concern on their part.

The **CHAIRMAN**. Thank you. Senator Graham.

OPENING STATEMENT OF SENATOR GRAHAM

Senator **GRAHAM**. Thank you, Mr. Chairman.

I, too, appreciate the fact that Chairman Volcker is here and I look forward to his wisdom.

We are concentrating largely on the funeral parlor where we're faced with almost a $100 billion cost of a decent burial. I am concerned with another issue, and that is what's happening in the emergency room where we have maybe up to another 500 institutions that are sliding toward insolvency. I would particularly be interested in the chairman's thoughts as to what we could do in order to suture those wounds and try to keep the problem from doubling in its proportion.

I appreciate the very distinguished service which the chairman has provided to this Nation in so many capacities and look forward to his help in this latest crisis.

The **CHAIRMAN**. Thank you.

Senator Kassebaum.

Senator **KASSEBAUM**. Thank you, Mr. Chairman.

I have always valued hearing Paul Volcker's observations and look forward to hearing them this morning particularly. Thank you.

The **CHAIRMAN**. Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator **GRAMM**. Mr. Chairman, I hardly recognized Chairman Volcker without his cigar. Maybe you've given them up as part of the austerity move that we're looking at in savings and loans and the budget.

Mr. Chairman, obviously we are all here today because we are interested in hearing the views of perhaps the most distinguished financial adviser of our era on a plan that is a very difficult plan. It's hard to write a plan to fill up a $50 billion hole and have people stand up and shout and applaud in support of it. I'm proud of the fact that our new President came up with a real program to address the problem.

The problem has been building for 15 years. We have had three Presidents and eight Congresses that have refused to deal with it. I think we have before us a plan that overall is a good plan. It's a plan that deals with the problem. It's a plan that not only tries to address the damage done by the horse that got out of the barn but it tries to close and lock the door to be sure that no other horses get out of the barn in the future.

It is a plan that, while involving taxpayers' money, sets up a procedure so that if we are successful, if the plan is bold and if the plan works, the taxpayer will be the first claimant on the benefits to be derived from it.

So while I think that clearly it's going to be a tough challenge to pay this money back, at least we have a fighting chance to do that, and I think that's important.

I share with my colleague from New York a belief in the importance of trying to recover the money by going after those who have abused the system. I am aware of the old adage that you can't get blood out of a turnip; but on the other hand, roughing up a turnip can make you feel good. And I think the committee is eager to get on with that task.

Finally, Mr. Chairman, I again want to congratulate you for the nonpartisan way that you have tried to address this problem. Rather than starting today, we really are beginning to focus in on the plan as the plan is arriving. We have been holding hearings from the very beginning of this session. I think it is very important that we come to a conclusion quickly. I would like to see us adopt some variant of this plan and do it quickly enough so that we don't have to have some kind of interim holding action. In that way we can keep the process of rebuilding the financial base of the thrifts alive. I think that if we could adopt some variant of this plan quickly we would save the taxpayer money. We would at least begin the process of getting this problem behind us.

Mr. Chairman, I want to congratulate you for your leadership in this area.

The CHAIRMAN. Thank you. I appreciate your kind comments.

Senator Sasser.

OPENING STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Mr. Chairman, I am pleased that we have before the Banking Committee today the distinguished former Chairman of the Federal Reserve Board, Paul Volcker. It is especially helpful that we have his enormous knowledge to draw on the day after the President's announcement of the S&L rescue plan.

Indeed, Mr. Chairman, I have a great deal of respect for Mr. Volcker's view on the regulation of the banking system. He believes, as you and I both do, that specialized financial institutions served our Nation well over most of the past half century.

No one can deny that until the 1980's the savings and loan industry did a fantastic job providing homeownership to millions of American families. But the industry did this in a structured, regulated and low interest rate environment—an environment markedly different from that of today.

Now it's probably too late to roll back the clock. We should, however, try to adapt the good points of the old system to the new one that we must create this year. Mr. Volcker has some good ideas in this respect.

But we must learn from what happened in the past. I might observe that the extraordinarily high interest rates of the late 1970's and early 1980's contributed to the decline of the traditional savings and loan industry. Exhorbitant interest rates sucked deposits from the regulated S&L's into the money market funds.

Savers reaped a windfall in those years. But there were resultant costs, most prominantly the one before us today. But the decline in homeownership in the 1980's is another less obvious cost.

Maybe there was no choice back then. Now we all must pay, in part, for what happened 10 years ago. In this case, the savings and loan industry will bear a heavy burden. But there will be a steep on-going cost to the Government.

And this cost to the Government—to the taxpayers—that results from what happened 10 years ago will be higher or lower depending on what interest rates do today. Indeed, it's most likely that bailout's on-budget interest costs are already at least 50 percent higher than those projected by President Bush.

So I think there's a message here for the present guardian of the Federal Reserve. We're walking a fine line. Just as they were a cause of the problem in the first place, I believe the course of interest rates will dictate more than any other factor, the ultimate liability of the taxpayers.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bond.

OPENING STATEMENT OF SENATOR BOND

Senator BOND. Thank you, Mr. Chairman.

I join with other members of the committee in expressing our delight that Paul Volcker is back with us again. Mr. Volcker, we always enjoy listening to your testimony and will be delighted to hear what you have to say even though you may not want to take a guess at the final figure. I think Senator D'Amato is getting up a pool so we can all see who gets closest to that number.

Mr. Chairman, I commend you on moving very quickly on the savings and loan issue. We have had hearings already. We were delighted to see the plan put forth by the President yesterday. As has been said already, no plan like this is easy or is going to be without pain. But I think several of the things we have discussed in the Banking Committee have already been noted in that plan.

Number one, it proposes to move forward with reform of this system before we throw the money into the system. I was particularly pleased, as several of my colleagues have noted, the emphasis put on enforcement. We need to have stiffer criminal penalties. I will be putting in the criminal fraud bill that I discussed with you and other members of the committee. That will not apply retroactively but it will serve as a notice for the future. I hope it will also be a strong expression of congressional direction to pursue criminal actions where they might not have been pursued with all diligence in the past. The $50 million from the recap funds to go into enforcement is an excellent move and we hope that they may be able to generate much more than that in recovered funds from directors, officers, and others who are responsible.

I, too, have found a great deal of sentiment among the people in my State for making every effort to get back as much as we recovered from those who have looted the system.

Finally, I think that what we've seen so far is an excellent example of bipartisan cooperation. The President made it clear that he was interested in what we had to say. All of us have had meetings—you with the President and others with the staff—and it's clear that the President read our quips and no new toaster tax was included. I think he also was very forthcoming in sharing with us the alternatives that were available. We have before us a package which should be a good starting point and I hope that we can show that the Banking Committee recognizes the seriousness of this and I would urge you to set a deadline, perhaps May or even earlier if you think possible, to get a piece of legislation moving so we can deal with a very serious problem.

Thank you, Mr. Chairman.

The CHAIRMAN. I might just say two things. We have a hearing on Thursday of this week on the fraud issue that several have mentioned. I hope the Attorney General will testify. Certainly high-ranking officials in the Justice Department will be here to talk about that.

In terms of acting, I'm hopeful that we can act much faster than that. It's not easy to do it, but I think we've just got to stay at it.

Let me now yield to Senator Sanford.

Senator SANFORD. Well, thank you very much. I certainly join my colleagues in expressing pleasure that, first of all, the President has been so prompt in sending us something and even more pleasure the fact that you are here to give us your advice and opinions. I look forward to working with the committee and with the administration in concluding this but, Mr. Chairman, I think I'll just put my statement in the record and not impose on the time any more.

The CHAIRMAN. Without objection, so ordered.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Thank you, Mr. Chairman. I would also like to thank Paul Volcker for his very helpful testimony. I am heartened to read how many of his thoughts for what needs to be done to shore up the FSLIC and to prevent this kind of crisis from ever occuring again are borne out in the plan that President Bush announced yesterday.

Indeed, I think we can all extend our praise to the President for his willingness to attack this problem head on and for submitting his plan to us so shortly after his inauguration. I believe his plan has a great deal of merit. It is an all encompassing plan that addresses both the need for funds to shore up the FSLIC and the need for substantial regulatory reforms to ensure that we never again are faced with this type of problem with our deposit insurance funds.

I know many of us have questions and even concerns about specific aspects of the plan, but I do think the President deserves to be complimented for his fine effort and that we need to begin work immediately to examine and refine the plan so that we can have legislation in place as soon as possible.

While I very much agree with many aspects of what the President has suggested, I am concerned that in financing the program through a new entity, the Restoration Trust Company, an off-budget enterprise, we are significantly raising the cost of resolving the FSLIC's financial woes. Indeed, some have suggested that the additional cost over direct Treasury borrowings could range from $600 million to $1 billion per year. This additional cost comes close to the revenues raised by the special premiums. I think this aspect of the plan deserves further attention.

Most well-run thrift institutions understandably feel that it is not fair or appropriate that they be called on to pay a huge part of the losses which, in the view, are not their fault. They take risks, as a matter of their business, but one risk they did not want nor accept, was the risk of sloppy supervision, lax rules, little pursuit of criminal actions, and general mismanagement by the responsible governmental agency, the Federal Home Loan Bank Board. The fault of that mess is that of the Government and the Government is going to have to pay its share for cleaning it up without adding unduly to the burdens of the healthy and honestly run institutions.

Again, I want to join my colleagues in welcoming you, Mr. Volcker, back to this hearing room and I look forward to hearing your comments on the FSLIC problems, on needed reforms to the deposit insurance system and any analysis you would care to give on the plan the President has outlined.

The CHAIRMAN. Senator Mack.

OPENING STATEMENT OF SENATOR MACK

Senator MACK. Thank you, Mr. Chairman.

It's a pleasure to be with you again, Mr. Volcker, and, unfortunately, I'm not going to be able to remain for your testimony. I did read your statement and would at this point just raise a couple of issues that I hope that during the discussions this morning will be touched on.

The cost of the insurance, the fee or the premium that's being raised for the purpose of solving the problem, and I would be interested in your response as to whether the fee is going to be so high that it's going to endanger marginal institutions.

Everyone has expressed the need or the concern for increased capital. In fact, I think in the President's plan it calls for doubling the capital for the industry by 1991 and I would be interested in your feelings as to whether that's feasible, can the market handle that and what your ideas are with respect to the makeup of that capital, subordinated debt and others.

Last, the area that the Federal Home Loan Bank System is to be placed under Treasury and would be interested in your thoughts as to whether there would be another place—for example, the Federal Reserve—in kind of overseeing the Federal Home Loan Bank System.

Again, I apologize for not being able to stay during the balance of the hearing but I do have another meeting and hearing that I need to go to and I would be interested in your responses to those.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Sarbanes.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. Thank you, Mr. Chairman. I will be very brief because I want to hear from Chairman Volcker.

I am pleased to welcome him back before the committee so early in the new Congress.

Mr. Chairman, I just want to say that I strongly welcome and agree with your view that if we are going to set a deadline for completing work on this it's going to be a lot earlier than May, which was the date that was put out by one of our colleagues. In fact, I again want to thank you for the very strong and prompt leadership which you have provided since taking over—even before taking over the committee officially as chairman in addressing this issue, and I am very supportive of your efforts to move this as quickly as we reasonably can to try to come to grips with this matter.

I do welcome the President's stepping forward yesterday and putting forth a plan and laying it on the table to become an object of not only our focus but the focus of various interested groups around the country.

The CHAIRMAN. Thank you very much for your personal comment.

Let me just note that with respect to the plan that the President announced yesterday, part of it involves administrative actions which are commencing today. There are a series of steps being taken literally as we speak to begin to deal with part of the problem and, of course, there's a remainder that requires legislative action which we will deal with.

Chairman Volcker, we are pleased that you agreed to be with us today. You've flown back from Japan to appear before us today and to share your thoughts on the savings and loan situation.

I know this committee feels your views are as valuable as any that we might seek to have. So, we are very grateful that you are here today as a private citizen to share your thoughts with us. You certainly have a record of a very distinguished public service over many years, and we appreciate that record.

I should note at the outset that you have indicated in your remarks that in your private capacity as chairman of the James D. Wolfensohn Co., that from time to time clients of yours have asked for general opinions about whether or not they should consider buying a failed or a healthy savings and loan and that the company from time to time has given advice in that vein. But that is not to be construed as direct involvement that would somehow indicate that you have some preconceived point of view or that have been heavily involved in that kind of activity as you have not been.

So in any event, with that, we would be very interested in hearing your views at this time.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, JAMES D. WOLFENSOHN INC.; FREDERICK H. SCHULTZ CLASS OF 1951 PROFESSOR OF INTERNATIONAL ECONOMIC POLICY AT PRINCETON UNIVERSITY

Mr. VOLCKER. Thank you very much, Mr. Chairman.

I have not been heavily involved in my private capacity, although as I indicate we may advise one firm that has taken over a savings and loan as to how it might operate it in the future, but we have nothing to do with negotiating any of these deals.

Let me say I am delighted to be back before this committee. I hadn't quite anticipated that we would be meeting together within 24 hours of the announcement of the administration program which took place while I was in transport back here. I've had a chance to at least partially read the papers this morning and I will try to respond to the nature of that program rather than reading my statement. You have my unvarnished preprogram ideas before you, uncontaminated by any consideration of what the administration might have proposed.

Let me say I do welcome the adminstration's initiative, as many of you have, this early in the session because, in part of my own feeling and in part of others' feeling on this committee, this is a problem that needs to be attacked just as soon as possible. The earlier that constructive decisions can be reached, the better.

I also think the President's program does more than touch upon the problem—it deals with each of the main points in your letter to me and each of the main points that I dealt with in my testimony. It has provided a very good base for your consideration of legislation based and for consideration of how to proceed in I think all important respects.

Let me just comment briefly on each of the main points as you laid them out and to which the administration has in effect responded.

IMMEDIATE INFUSION OF FUNDS

First of all, there is the need for injecting a sizable amount of funds promptly so that the FSLIC, or whatever body is going to administer the funds, can deal with these failed institutions in an expeditious way and in an effective way and in an efficient way. They haven't been able to do that up until now because they simply haven't had the funds available for providing cash payments, which may indeed be the most efficient and effective way of dealing with many of these situations.

So the program is directly responsive to that need and it does it in a way that would combine the provision of cash with certain regulatory and supervisory reforms of a rather basic character. Senator Garn and others here emphasized the need to combine those two aspects. I emphasize that in my own statement and the program is certainly responsive to that basic consideration.

Now it does provide a financing mechanism that's a little complicated. I think that particular financing mechanism is designed to avoid an immediate budgetary impact. It is not the way I implicitly or explicitly shaped my own statement, although I recognized that was a possibility.

I do share what might be the fundamental point behind that bit of financial engineering. I don't think it would be correct to consider these extraordinary expenditures for dealing with the savings and loan crisis as quite the same thing as an ordinary budget expenditure. I don't think they would have an inflationary impact. The financing that is involved is in effect paid out to depositors who in turn, directly or indirectly buy back the bonds. It's a kind of circular flow of cash. I don't think it is the kind of expenditure, however it is financed, in other words, that requires an offsetting revenue stream immediately.

There are interest costs entailed that will require down the road an offsetting revenue stream. That has to be taken into account in budgetary planning. What I suggested in my statement is that, if the cash need is financed straightforwardly by the Treasury, you should in effect exempt that financing from the Gramm-Rudman-Hollings strictures because I don't think they should be on the same basis as other Government expenditures.

The important thing is not to find excuses or precedents or whatever for getting around for what I see is the continuing need to move toward budgetary balance and surplus. This may inevitably be a kind of odd jog in the path, but it's important to maintain that basic path.

The President's program does divide up the ultimate cost between the public purse—I'm inclined to say the taxpayer, but the taxpayer doesn't pay for all the Government expenditures these days—and banks, savings and loans, and their customers. I think it's appropriate there be some division of cost in that respect. Just where that line is drawn is a very difficult one. My sense is, in responding to Senator Mack, that the increases in insurance premiums provided here go toward what I might personally consider the edge of viability in terms of not undermining the health and viability of the banking system and the savings and loan system which is in, as you know, very heavy competition, not only among themselves but with other elements in the money markets and the financial markets.

FUTURE OF THE THRIFT INDUSTRY

The second question you raised and I dealt with is what do you do with the thrift industry in the future—is there a desirability of maintaining a thrift industry? As I understand this program, it would maintain the thrift industry. I suggest in my own statement that I see good reason for maintaining it insofar as thrifts in fact concentrate on home lending. I don't myself see much justification for a thrift industry that is not a thrift industry in the sense that it doesn't concentrate on home financing.

Without reading the details and the fine print of the adminstration's program, I don't know whether there's any reflection of that distinction at all. It does apparently keep the basic idea of a thrift industry which to my mind implies support for home financing and home building as a special aspect.

STRUCTURAL AND REGULATORY CHANGES

The program is certainly responsive to the third point that you raised, a very fundamental point. It looks at the regulatory and supervisory system and proposes some basic changes. Some of them very much parallel the points that I made in my own statement—capital requirements and aligning those capital requirements as I understand it with the commercial banking system, I don't know whether the announcement says anything explicitly, but it's certainly in the spirit of what is proposed to align accounting standards and examination standards with those prevailing in the commercial banking area.

The program parallels entirely, as I understand it, what I say in my statement about some powers of the FDIC—powers of early closing, of the ability to withdraw insurance for safety and soundness reasons more expeditiously. I suppose it covers by implication something that you emphasized in your opening statement and that I emphasized in my statement; I don't think it is appropriate for the Federal Government through the FSLIC to be providing insurance for institutions exercising powers provided in State charters that are in fact inconsistent with the kind of safety and soundness considerations that a prudent insurance agency should want.

I would look forward to rather explicit direction to the FDIC or the FSLIC on that point. The program does, as I understand it, combine the administrative aspects of the FSLIC and the FDIC, which is a basic point that parallels one I made in my statement.

Finally, I don't think the administration has said much, but I understand they may be calling for a study, about reforming the insurance system and the mechanisms of the insurance system as opposed to the supervisory and regulatory system. I think it's probably appropriate at this point that they don't say much, if anything, and have a study. That's a very complicated issue which I think should be looked at. I hope this committee will look at it over time, but I think the nature of the issue is such that it may be difficult to reach judgments in the kind of urgent timeframe that you are now talking about.

So I would support the notion that you go ahead as expeditiously as you can with getting the money in there and getting the regulatory and supervisory reforms, but I hope recognizing at the same time you should come back and look at the insurance system and the way that it operates on the basis of a little more study.

I myself suggest that I don't think the present crisis requires, a root and branch reform, but I think there are aspects to be looked at. I make one proposal in my statement, but I'm perfectly happy to see that passed over for the moment. I think it should be part of a more basic consideration as to whether you really want more basic reforms in the insurance system—this whole question of precisely what level of deposits should be insured, the whole controversy about whether there are banks that are too big to fail, and whether there should be elements of coinsurance. The item that I present is to whether there shouldn't usefully be a layer of subordinated debt added to the capital of these depository institutions that very clearly would not be insured but would provide an additional element of market discipline on managers in operating these financial institutions.

Those are my first reactions in responding at least to newspaper reports of the administration program, while also making some allusions to what I outlined in my statement. So with that much discussion, I would be glad to respond to your questions, Mr. Chairman.

[The complete prepared statement of Mr. Paul Volcker follows:]

STATEMENT OF PAUL A VOLCKER
before the
UNITED STATES SENATE COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS
10 A.M.
February 7, 1989

Mr. Chairman and Members of the Committee:

I am honored to be asked to appear again before this Committee in an unofficial and personal capacity.

Your letter of invitation emphasized that an orderly and constructive resolution of the costly crisis that has engulfed much of the savings and loan industry must be the "top priority" of both the Committee and the Administration. In pursuing that objective, you have asked me to focus on three areas of concern: (1) the appropriate method of financing the sums that will be necessary to make good on the Government guarantee of savings and loan depositors; (2) the need for, and the viability of, a separately regulated thrift industry; and (3) needed "regulatory and structural" changes to ensure that the current problems do not recur in the decades ahead.

Mr. Volcker is Chairman, James D. Wolfensohn Incorporated and Frederick H. Schultz Class of 1951 Professor of International Economic Policy at Princeton University

I hope these brief prepared comments are responsive to those questions. However, I should also point out that it is about 18 months since I left an official position and was closely in touch with both the data and current developments. I am, in the circumstances, acutely aware of the enormous difference between expressing, as a private observer, the kind of broad policy judgments that I will make today and the much heavier responsibility before you and the Administration of translating any broad approach into precise, workable, and constructive legislation and administration.

I might also note that in my private capacity as Chairman of James D. Wolfensohn Inc. I have from time to time been asked by clients or others to express some general opinion about the wisdom of purchasing either failed or healthy savings and loans. However, in no case have I or the firm acted on behalf of any client in such a transaction. While we do contemplate advising one firm concerning the operation of an already acquired thrift, as I noted at the start, this statement reflects entirely my personal view.

The main points I will emphasize are:

1. Very substantial funds beyond the present or any prospective capacity of the FSLIC alone to raise money will be required to meet the commitment to protect depositors of failed savings and loans. It also appears likely that public funds will be required to meet already committed debt service requirements of the FSLIC.

> I believe large additional cash resources should be made available promptly to the FSLIC so that it can proceed to deal with the large number of remaining insolvent insured associations in the most effective and economical way possible. Specifically, the choices made in resolving particular insolvencies -- by liquidation, by sale with assistance, by sale of a "clean" institution with bad assets otherwise disposed of, or by other means -- should be made on grounds of least ultimate cost to the taxpayer, appropriate market incentives for the acquirors and other public interest criteria; they should not be constrained by lack of cash.
>
> 2. The need for a separate structure of regulation and support for specialized home mortgage lenders has, as a matter of public housing policy, been diminished by greater competition and technological change in the mortgage market. However, recent experience strongly suggests "traditional" thrifts -- those clearly emphasizing home finance in their lending and primarily dealing with individuals -- can remain profitable and competitive. I see no compelling purpose, assuming suitable regulatory and supervisory reforms, in dismantling the traditional savings and loan industry and the Federal Home Loan Bank System. However, I see no public policy rationale for maintaining a diversified thrift industry essentially parallel to, but separate from, commercial banking. Such institutions should be regulated and supervised as commercial banks.
>
> 3. The enormous support from public funds required to deal with the present thrift crisis is testimony enough of the need for some basic changes both in the way thrifts are regulated and supervised and in the way the insurance system is operated. Urgently needed regulatory changes should be agreed upon and legislated as part of the provision of new funds. Some desirable structural reforms in deposit insurance might require longer consideration and in any event would need to be delayed in implementation.

Financing the Rescue

I have no independent estimate of the total amount of funds that will be necessary to meet the insurance obligations of the FSLIC. Judging from the estimates

of the GAO and others, however, it appears clear enough that tens of billions of dollars will be required beyond any amounts that reasonably and equitably could be raised from FSLIC-insured institutions alone.

With the special assessment now in place, FSLIC-insured institutions for some years could be required to pay an insurance premium of over 1/5 per cent on deposits. In my judgment, substantially heavier insurance fees than presently in force would raise substantial questions about the competitive viability of the now profitable parts of the industry. At some point, a higher premium, and one kept indefinitely in place, would be self-defeating as a revenue measure and in terms of any public policy objective of maintaining a healthy specialized thrift industry.

I understand that the idea of spreading the full cost of the necessary infusion of new cash over the entire group of insured depositary institutions (and their depositors) has also been considered. I am doubtful, to put it mildly, of the practicality and desirability of such an approach. The result would be to place all U.S. depository institutions, specifically including those that have already suffered competitively from the aggressive practices and loose supervision of failed and failing institutions, at a further strong competitive disadvantage in domestic and international markets. Among other problems, perverse incentives would be created to engage more heavily in risky lending and trading activity, the kind of thing partly responsible for today's problems. The ultimate outcome would, it seems to me, be entirely contrary to the basic public policy interest in a strong and competitively healthy banking system.

In practice, deposit insurance premiums have already been significantly increased in recent years. Looking ahead, perhaps authority could be provided for some limited further increases if deemed necessary in the light of experience to protect the FDIC fund. Such a forward looking approach would be different than asking the commercial banking system to bear the lions share of the accumulated problems of the FSLIC.

While the FHL Banks might be able to provide some limited additional funds, the implication is that a large share of the costs of making good on the deposit guarantee commitments must, sooner or later and directly or indirectly, be borne by the public purse. By ingenious financial devices, it might be possible to defer the cash and budgetary impacts. However, provided adequate controls are in place, there are strong reasons for providing cash resources to the FSLIC sooner rather than later.

As a general matter, the quicker insolvent institutions are closed, the lower the ultimate cost. The method of choice for handling a particular closure -- primarily between liquidation with cash payment to depositors and the sale to new owners supported by FSLIC cash or credit -- should be decided primarily on grounds of least cost and least future risk. But now, the option to pay cash "up front" is not possible, and there are doubts about the ultimate ability of the FSLIC to service notes offered in lieu of cash assistance. The net result is unnecessary increases in the costs of assistance packages and possible perverse incentives for the new owners of failed institutions.

In an economic sense, the immediate cash and budgetary expenditures involved in meeting insurance obligations reflect recognition of losses already incurred and should not have substantial expansionary or inflationary effects on current economic activity. The related interest costs from current borrowings will, indeed, extend indefinitely into the future and certainly need to be taken into account in shaping future fiscal and budgetary policy. However, a logical case can be made for adjusting the Graham - Rudman - Hollings calculations to take account of the extraordinary increase in FSLIC expenditures, or, perhaps, exempting them.

I make the point conscious of the danger of creating a political precedent for other, economically unjustified, exceptions. You are familiar with my strong concern about placing the budget on a path toward balance and surplus in the first half of the 1990's. Plainly, the kind of special treatment I envisage would need to be contained to these unique circumstances if we are to maintain the needed budget discipline.

The Future Role of the Thrift Industry

The economic losses in the thrift industry reflect an amalgam of forces, including sharply depressed economic conditions in the Southwest and weaknesses in past regulatory and supervisory policies. But it is also my clear impression that the largest losses have been concentrated in institutions moving away from home mortgage lending and aggressively exploiting -- at times to the point of self-dealing and fraud -- some new or broadened powers provided thrifts in recent years, especially by some states. The key areas of concern have been real estate development and highly aggressive lending on commercial real estate.

At the same time, a large number of thrifts which have continued to concentrate their lending on home mortgages have restored profitability after the interest rate squeeze in the early 1980's. Those institutions include many of the largest institutions and most of those oriented toward

serving and drawing funds from their local communities. To be sure, such specialized savings and loans have been required to adjust their methods of operation, holding adjustable rather than fixed rate mortgages and typically providing a broader range of deposit and lending services to individual customers.

Those savings and loans are not so crucial a part of the mortgage market as they were earlier in the post-war period. But I see no urgent reason to substantially change the basic rules of the game --including access to, and supervision by, the Federal Home Loan Bank System-- for institutions that wish to remain heavily committed to home mortgages. There is, however, an important proviso: regulatory and supervisory standards and performance do need to be enhanced, and institutional changes should be introduced to better assure that stronger standards are maintained.

The public policy purpose served by a so-called thrift that wishes to exercise broadly diversified deposit, lending, and investment powers escapes me. If those institutions wish to have the powers of a commercial bank and if they can meet safety and soundness standards, then it seems to me they should be provided a commercial bank charter and be regulated as a bank. If they cannot be brought to meet safety and soundness standards, they should be liquidated or acquired by stronger institutions, specifically including commercial banks that can meet the standards. If commercial bank or bank holding company powers, as a matter of public policy, are too narrowly circumscribed in some respects (and I believe they are, certainly in the securities area and some others), then those powers ought to be broadened for all institutions exercising banking powers, not just for a group of institutions subject to a special regulatory regime. To the extent diversified thrifts have been exercising powers that, in the light of experience, are simply inappropriate for insured depository institutions, or they have been exercising broader powers without effective regulation and supervision, then those powers and those regulatory inadequacies should be ended.

In sum, I see no need for a special regulatory and supervisory apparatus for diversified thrifts; they should instead be regulated and supervised as commercial banks. I am aware that the stresses within parts of the structure of commercial banking, and the large losses that have been incurred, suggest review of supervisory powers and practices in that industry as well. But from this vantage point, the most urgent need for reform lies with the thrifts.

Structural and Regulatory Changes

Assuming that a more traditional thrift industry, oriented primarily toward home mortgage origination and

lending, remains alongside commercial banks, then important questions arise about how their regulation and supervision might be strengthened. In that connection, I believe steps should be taken to better protect the integrity, independence and professional competence of the Federal Home Loan Bank System against industry and political pressures.

One approach would be to require by law that basic accounting and capital requirements be appropriately aligned with rules applicable to commercial banks. Steps should be taken to assure that members of the Home Loan Bank Board and the Boards of the individual Home Loan Banks are not dominated by those with ties to the savings and loan or housing industries. The National Housing Act should itself be rewritten to eliminate the implied encouragement of the regulatory authorities to act as industry "cheerleaders."

More important, the present crisis seems to me to have ended any rationale for an insurance agency closely aligned with the FHLBB and separate from the FDIC. The FDIC could become the independent Federal insuring agency for both banks and surviving thrifts that meet its standards. At the same time, the FDIC should be provided both clearer direction and more effective authority to withdraw insurance from institutions operating in an unsafe manner. Moreover, experience with extremely liberal state thrift charters seems to me to provide unambiguous evidence of abuse of Federal insurance. The FDIC should have the authority (and the will) to refuse insurance to those state-chartered institutions exercising powers, beyond those provided by a Federal charter, that pose significant additional risk to the insurance fund.

As I indicated earlier, I do not mean to imply that commercial banks' regulatory or supervisory standards do not need review as well, although losses thrown back to the FDIC have been confined within that institution's capacity to pay. The thrift experience plainly raises additional warning flags about the wisdom of banks or bank holding companies entering into the field of real estate development where temptations for self-dealing, conflicts of interest, and even fraud appear so great. Industry standards with respect to commercial real estate lending certainly need review. Appropriate supervisory standards for leveraged buy-outs and other new lending areas are, I understand, currently receiving attention. Conversely, the opportunity could be taken to provide the kind of straight forward legislative authority (with safeguards) for bank holding companies to enter the securities area that this Committee developed last year.

Even more difficult structural questions are raised about the nature of the system of deposit insurance itself. We have clearly seen that, under certain circumstances, such as actual or approaching insolvency, there are strong incentives for excessive risktaking. The availability of insured deposits provides the wherewithal for undertaking those activities, placing the insurance funds rather than private capital in jeopardy.

My own sense is that "root and branch" reform of the insurance system is not necessary to deal effectively with that "moral hazard" problem. After all, the strength of many thousands of banks and thrifts operating within the framework of the current insurance system suggests that its flaws are not so fundamental as to require starting from scratch in making reforms. Moreover, any stricter limits on actual insurance coverage would have to be introduced with great caution, and only with long advance notice, lest depositor confidence be shaken.

For all that, there are a few areas where experience points to the desirability of certain changes that could be introduced at an early date:

- There should be effective means of limiting growth in brokered deposits, if indeed such deposits should be permitted at all. These deposits often fueled the growth of institutions taking excessive risks.

- Adequate capital standards should be applied to banks and thrifts alike -- and substantial progress is already being made in that direction. Supervising agencies should be authorized and encouraged to move more promptly and forcibly as as capital is impaired below industry guidelines.

Finally, consistent with the broad thrust and structure of the new capital standards for banks, serious consideration should be given now to an approach that could significantly increase market discipline and reduce future claims on the insurance fund without undermining depositor confidence. Specifically, a significant component of medium or long-term subordinated debt -- debt which would be clearly at risk in the case of insolvency -- could be required in the capital structure of banks and thrifts. (Technically, the effect would be similar to increasing the new "tier two" capital requirements for banks and permitting that increase to be satisfied by subordinated debt.)

The sale of such debt should not be particularly costly for conservative and well-managed institutions. It would, however, require that an institution recurrently face a market test of its ability to raise medium or long-term funds that would in no instance be protected by the deposit insurance agency.

Other possible changes in the structure of deposit insurance -- such as changes in the basic amounts insured, the possibility of a system of co-insurance on large deposits, and the like -- seem to me at the least premature. They should, in my opinion, be deferred for further study and not delay more obviously needed reforms.

The **Chairman**. Well, those are very helpful comments and observations along with your detailed statement which, as you say, has the value of having been prepared and submitted in advance of the proposal so it is in a sense a completely independent point of view.

Let me acknowledge that Senator Pressler has come in. Before I start my questioning, Senator Pressler, did you have a brief opening comment that you wanted to make?

Senator **Pressler**. Thank you, Mr. Chairman. I have an opening statement which I would like to place in the record.

Thank you very much.

The **Chairman**. Without objection, so ordered.

OPENING STATEMENT OF SENATOR PRESSLER

Senator **Pressler**. Mr. Chairman, I wish to commend you for inviting our distinguished witness to appear before the committee today. His three decades of public service—culminating in 8 years of service as Chairman of the Federal Reserve Board—has been truly outstanding. I join the other members of the committee in welcoming you here today, Chairman Volcker. It must be a relief to occasionally come to Washington and not have to commute, as you did for so long a time.

We appreciate your taking the time to share your views with us on the crisis in the thrift industry. I shall look forward to hearing from you further on this most important subject. Thank you, Mr. Chairman.

The **Chairman**. Let me just ask you this to begin. You mentioned the financing mechanism in the plan as nearly as you were able to understand it reading the news accounts this morning, and I realize you're a bit handicapped in that you were out of the country until a few hours ago. But it looks a little complicated, to use your words, and I think that's a fair description, that some financial engineering has been done to structure the financing side of the plan to accomplish a series of objectives.

It appears to me that one effect of that is that in order to try to work around some of the Gramm-Rudman constraints an effort has been made to do some of the financing in effect in an off-budget manner. That will require selling bonds with some premium interest rate on them because they will not be direct Treasury obligations. And there are different estimates as to what that cost may be. I heard one estimate today from one individual who's tried to assess it that it might average as much as $400 million a year each year out over 30 years. I don't know whether that figure is right, and I'm sure we will get other estimates.

Some have argued that whatever the premium is, you have to be willing to accept that because if you were to have a one-shot exemption to Gramm-Rudman, that would be seen by international observers as caving in on the budget discipline. They would then become so dismayed by that that we would get all kinds of other negative repercussions that would force us to have to go to a modified off-budget route and pay the financing premium in order to make it appear as if we're not really increasing the deficit.

I'd like your thoughts on that. I'd like your thoughts on the degree to which it may be prudent to take some premium costs in order to try to present this in a certain way and also your view on whether the international community would penalize us if we just took a very straightforward approach to this thing and borrowed at the lowest rate. What would be your thought on that?

Mr. VOLCKER. Well, we are in the area of psychology and I wish to note that at the start.

The CHAIRMAN. I understand.

EXTRA PREMIUM COST

Mr. VOLCKER. That bears upon the extra premium cost that's involved too. I think so far as the extra premium cost, a good deal depends upon how the legislation is written and I've not read enough about it in terms of the time that I've had. If all the interest is in effect guaranteed and you have a large volume of these bonds so you have the prospect of a reasonably liquid market, I think there will be some extra premium costs but I wouldn't think it would be as large a total as you mentioned. I wouldn't think it would be anywhere near that large. But that depends upon how the law is written.

I think you have a difficult problem of explaining this to the domestic community and to the international community regardless of what we do in terms of whether it's on-budget or off-budget. There's going to be a large volume of bonds issued. That is the nature of the situation. The losses are implicitly there already. As I indicated, in a real economic sense I don't think it's meaningful to think of that as a 1 or 2 year addition to the budget deficit. I think that's what has to be emphasized in explaining however you do it. Now doing it the way the adminstration proposes may appear to make it a little simpler because it does not appear in the budgetary figures per se. But you still have to explain why you're going through something of a rigmarole to avoid that.

I'm not sure that I would make the decision primarily on those grounds. I have heard the argument that if you do do it straightforwardly and then exempt it from Gramm-Rudman, you are creating a very difficult precedent for avoiding and exempting other things from Gramm-Rudman. I think that is a fair point.

What worries me just a bit about this way of doing it is you may create precedents for other kinds of fancy financing for other programs that would take those off-budget.

I think either way you do it there is a substantive reason for considering some temporary allowance in what otherwise would be an appropriate budgetary path. So I don't disagree with that part at all. In both cases you have to worry about this precedent being used in cases where it does not have the economic justification that this particular program, to my mind, has.

The CHAIRMAN. Wouldn't international observers, predictably the financial market people, aren't they pretty sophisticated? Don't they look past the surface treatment? Don't they understand precisely what the financial consequences and actions are that we're taking here?

Mr. **Volcker**. I would hope they could understand it. As I say, I think you've got a problem either way. I think you can overestimate the sophistication of a market's reaction and the budgetary number itself has some significance because people are used to it and it's a single, simple number that goes out over the tickers and in the newspaper stories and it's only the third or fourth paragraph that begins explaining it the other way. There is a difficulty there, but I think to some degree the difficulty lies in either approach.

The **Chairman**. Very good.

Senator Garn.

Senator **Garn**. Thank you, Mr. Chairman.

Chairman Volcker, as you well remember, back in the late 1970's you and I and others suffered through the extremely difficult problem of the prime rate going to 21 percent and money market accounts paying 17 or 18 percent, and banks paying 5¼ and 5½ percent. So in 1980 and 1982, we phased out those interest rate ceilings because there was a disintermediation and there were $300 billion that flowed out of traditional depository institutions into the money market accounts. The competition for money wasn't any competition at all. So we removed those interest rate ceilings and decided, OK, the depository institutions will be able to compete and pay money market rates, whatever they are.

Well, it's interesting to me that over the last few months on any given day the spread between interest paid by the money market accounts is around 175 to 200 basis points. So there will obviously be a debate to come over increasing the banks to 15 basis points and the thrifts to 23 and then down to 18 after 3 years—they obviously won't like to pay increased premiums.

But is it fair or am I just rationalizing to say that deposit insurance has dramatically reduced the cost of money to those institutions? I would think after all these years—6 years—since we deregulated, that there are a large number of people out there who would say, "If you put the safety and soundness of that FDIC sticker on the door or a FSLIC sticker on the door, I'm willing to take 1.75 or 2 percent less interest." So if there wasn't deposit insurance and we didn't have premiums, wouldn't the cost of money then logically be much higher?

What I want to know is if my logic is wrong that deposit insurance has actually saved these institutions a lot of money in their cost of operation over the years?

HAS DEPOSIT INSURANCE SAVED INSTITUTIONS MONEY?

Mr. **Volcker**. I think if you look at them overall that must be the case currently. I don't know how much it was the case 10 or 15 years ago when people were not concerned about the safety and soundness of their financial institutions.

Senator **Garn**. I'm talking about now.

Mr. **Volcker**. Currently, I don't think there's any doubt about that on the average. Now, of course, you get into a problem that some institutions who think that they are run very conservatively—and indeed may be and aren't going to have any question raised about them—feel that in their particular case they are not benefiting at all or significantly from deposit insurance. At the same time, one of their brethren that may be operating in a very aggressive manner may be totally dependent upon deposit insurance to raise money.

So you've got those inter- and intra-industry differences which I think goes back to your problem in setting the insurance fee. There will be elements in the savings and loan industry who say:

> Look, we've been operating very prudently and indeed have been all along. We are now reasonably profitable. We have largely home mortgages for which there is no substantial credit risk. Why do we have to carry the load for those elements in our industry that have been dependent upon private insurance and of course have been greatly benefited in the rate of interest that they pay?

Senator GARN. Well, my 16-year-old son doesn't understand why his car insurance premiums are three times what mine are because he's obviously a much better driver than I am. There's no doubt about that.

Mr. VOLCKER. In this area, they are the same for everybody.

Senator GARN. But that's my next point because I expected you to answer in that manner. Then this would argue in the longer term, not obviously in the short-term solution, for looking at risk-based capital.

Mr. VOLCKER. Right. Risk-based capital or risk-based premiums or both?

Senator GARN. Well, either or both. I tend toward risk-based capital because if somebody wants to put money in some riskier venture, OK. That may be much easier to devise a system for than rating on the basis of premium. It amounts to the same thing.

Mr. VOLCKER. I happen to agree that risk-based capital is easier to administer than risk-based insurance premiums and it's appropriate.

Senator GARN. The administration also is recommending that the Federal Home Loan Bank Board be a subagency of the Department of Treasury and they are modeling this after the office of the Comptroller of the Currency—OK, we separate out FSLIC from the regulator and because the Comptroller, the national bank regulator, is under Treasury, then we're going to have the Federal Home Loan Bank Board under Treasury.

Now I completely agree that we need to separate the insurance function and that we need to make sure that the increased FDIC premiums are not used in the thrift area. But my own preference would be that the Federal Home Loan Bank Board still maintain its independence while having that separation, rather than go to Treasury.

What is your opinion of that relationship? I know you certainly never wanted to be under Treasury as Chairman of the Fed.

Mr. VOLCKER. That thought has occurred to me, Mr. Garn, and I wouldn't want to see this precedent applied to the Federal Reserve.

I think this is a kind of philosophical question that's quite apart in some sense from this immediate savings and loan crisis. I would come out, frankly, where you come out. I think there is a role for independent agencies with more than one administrator. I think there is value in having a board and a board that has suitable diversity.

So on that particular point, I think my instinct would be toward retaining the Federal Home Loan Bank Board as an entity but probably reforming the membership and reforming the method of appointing the directors of the Home Loan Banks, which I guess they did in this program, but leaving it as an independent agency. That has been a philosophy I have held for some time with respect to banking supervision.

Senator GARN. Well, I feel that way and you've got a different structure than the Comptroller. You've 12 regional banks out there and it is a different structure than the Comptroller.

Mr. VOLCKER. I do agree with the point that you alluded to that is in their program—of course, it's in my statement, too—I think it is a good idea to take the FSLIC and break that marriage with the Federal Home Loan Bank Board and incorporate it administratively with FDIC. So on that basic point I'm in full agreement.

Senator GARN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Let me acknowledge three others that have joined us and quickly ask, before yielding to Senator Cranston for his questioning period, Senator Shelby, did you want to make an opening comment?

Senator SHELBY. Mr. Chairman, thank you. I have an opening statement that I ask unanimous consent be made part of the record.

The CHAIRMAN. Without objection.

STATEMENT OF SENATOR RICHARD SHELBY

Senator SHELBY. Mr. Chairman, I commend you for scheduling today's witness. Although he has gone on to other endeavors, he remains one of the most respected witnesses to testify before this committee.

Chairman Volker, I have read your testimony and appreciate your candor. As one might expect, your recommendations are straightforward and well-laced with common sense.

Yesterday, we were all pleased to see the proposal from the administration. I say "pleased," because regardless of your viewpoint, I believe that we are all relieved to see something on the table. Moreover, we are delighted that it is viable. It is certainly more clever than earlier suggestions.

At this time, my biggest concern is that we should act quickly. The Treasury proposal is a good foundation. Legislation is necessary to implement a resolution and the legislative process is often agonizingly slow. It is during this process, however, that we will verify the presumptions of the administration's proposal. I am concerned that we are assuming the restoration to health of a very sick industry, even after continuing to bleed it with the special assessment, indeed an increased special assessment. I support having the industry pay for as much as is possible but I want to ensure that we are not killing the patient with the cure.

This proposal also fails to address the question of whether there is a continued need for a separate thrift industry. As Chairman Volcker points out, technology in the marketplace, specifically the securitization of mortgages, has had a dramatic impact on the availability of mortgage credit. I believe we need to explore that question in greater detail before making decisions on a solution.

However, having expressed these reservations, I want to stress that I am mindful of the urgency to act. We are faced with choices that have important consequences on the ultimate cost of the cleanup. We can act quickly and the snowball of costs will be smaller; we can include the solution, or parts of the solution, in the budget and its cost will be less. I believe we owe it to those who are footing some of the bill, the taxpayers, to make the right choices.

Mr. Chairman, I'll conclude my comments by saying that I think the administration's proposal is a good blueprint. I would like to see this committee consider legislation as soon as possible.

I look forward to questioning our distinguished witness.

The **Chairman**. Senator Dodd.

Senator **Dodd**. No statement. I'm just delighted to see Mr. Volcker.

The **Chairman**. Senator Wirth?

Senator **Wirth**. I just want to welcome Chairman Volcker here.

The **Chairman**. I have a statement from Senator Dixon for insertion in the record.

STATEMENT OF SENATOR ALAN DIXON

Senator **Dixon**. Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee continues its series of hearings on the thrift crisis. I look forward to hearing the testimony of the distinguished former Chairman of the Federal Reserve Board, Paul Volcker. I know his comments will be extremely helpful to the committee as we work toward legislation that will solve the problem.

I would like to take this opportunity to make a few comments on the administration's thrift proposal. I believe it represents real progress toward getting the thrift crisis behind us. It shares many of the principles I and other members of the Banking Committee have been discussing:

It doesn't tax savers;

It doesn't attempt to resolve the savings and loan problem by creating a problem in the banking industry or elsewhere in the economy;

It restores the kind of regulatory supervision that has been missing in recent years;

This is a tough proposal. It is tough on the savings and loan industry, but it has to be tough. The problem is too big for a painless solution. This proposal spreads the pain, while ensuring that no depositor at an S&L will lose a dime.

This is an expensive proposal it would be nice if we didn't have to raise $50 billion by issuing bonds. It would be nice if no taxpayer funds were needed. We do not have the luxury, though, of not facing this problem. We've waited too long already. The simple, hard, truth is that we must address this problem and that spending of the magnitude President Bush has proposed is absolutely essential.

Of course, the proposal needs further review. For example, it is not yet clear how soon this proposal will give us an S&L insurance fund that will be able to meet any future problems without the risk of further taxpayer assistance. It appears to be several years away. We also need to look carefully at the proposal to ensure that the complex financial structure it proposes is the most cost-effective alternative available. And, of course, we need to carefully consider how we are going to fit this proposal into the Federal budgets for the next decade and more.

This plan is not out in left field, though. It is a good starting point for the legislation we need. I look forward to working with President Bush, Secretary Brady, the Federal banking and savings and loan industry regulators, and my colleagues here and in the House of Representatives in a cooperative effort to get sound legislation quickly enacted.

Thank you, Mr. Chairman.

The CHAIRMAN. You can see that there's great interest in your views.

Mr. VOLCKER. More interest than when I used to be Chairman of the Federal Reserve Board.

The CHAIRMAN. Absence makes the heart grow fonder.

Senator GRAMM. We trust you now.

Senator SARBANES. We think we might learn something today and you'll speak a little more candidly.

Senator GRAMM. You have been promoted to private citizen status now.

The CHAIRMAN. Let me now yield to Senator Cranston for his questioning period.

Senator CRANSTON. If the insurance premiums on FSLIC and FDIC rise further as anticipated by the administration proposal, do you see the mutual funds as a threat to the regulated financial industry?

Mr. VOLCKER. Well, the mutual funds are obviously a strong competitor anyway and this makes it a little bit more difficult. It works in that direction. This, of course, will raise the FSLIC insurance very little for a few years. It's not going to be terribly visible. I express in my statement the very real limitations on raising the FSLIC premium, particularly if comparable costs aren't going to be spread over some of the competitors. But this is relatively small and then I think it begins going down. The more significant in terms of change is the banks. The premiums for banks are left lower than for savings and loans under the administration proposal. It is a not an insignificant additional cost for banks, which I—just looked at in a vacuum—don't like to see. I think the banks are having enough problems competing now and I like to see a strong, healthy banking system. So I don't particularly like any additional burdens put on them.

But let me say, on the other side, I think there is some rationale for strengthening the insurance fund, the FDIC fund, and for sending some message to the banks that when they have difficulties, as they do as an industry—not every bank obviously, but some banks and it's been costing the FDIC money—that the industry as a whole has an additional burden. It gives the industry an incentive I think to support appropriate regulatory and supervisory restraints on the outlyers, on the ones that are the source of the difficulty.

So there is some merit in adjusting insurance premiums if there is a case in terms of the needs of the FDIC fund itself.

Senator CRANSTON. Who are the banks having the greatest difficulty presently in competing with?

GREATEST COMPETITION FOR BANKS

Mr. VOLCKER. Well, I think that is a pretty general phenomena. I thought you were going to say which banks are having the greatest difficulty and that's——

Senator CRANSTON. The banking industry generally is having the most trouble with what other industry?

Mr. VOLCKER. I think very frankly the difficulties are general. When you talk about competition strictly with money market funds, it would be banks that are heavily involved in consumer business. Most of them are so involved, but in different relative amounts.

But it's not just the question of the money market funds. The big wholesale banks that may not be so heavily in the retail business are in heavy competition every day with the commercial paper market, with other outlets of funds for their big corporate customers, and they work under very thin margins. If you're operating in the Eurodollar market, the margin is going to be ⅛th to 1/16th percent. You're only talking about 1/12th percent in current banking insurance premium and this proposal would raise it to something like ⅙th of a percent. It gets pretty significant in terms of the competition in wholesale markets.

To illustrate the problem, I assume—I don't know this for certain—I assume the insurance premium is not being applied to deposits in overseas offices. It does not apply to those deposits now. If it did, it would be very difficult for U.S. banks to compete in the Eurodollar market where the margins are very thin relative to this kind of insurance charge.

I don't think the proposed charge is being applied to those deposits, but it's illustrative of the difficulty. When it's not applied to deposits in overseas offices, there is an incentive to move deposits from domestic offices to overseas offices to avoid the insurance charges.

So there are definite costs involved here. As I say, my judgment is this proposal goes toward the limits of what's tolerable—the administration's proposal—but I can't say that it's intolerable as it is. I think there is some value in recognizing quite simply the additional costs of the FDIC—paralleling but much more moderate than the FSLIC problem.

Senator CRANSTON. In 1980 you indicated a belief that perhaps it would be necessary to have some reserves on mutual funds. How do you feel about that now?

Mr. VOLCKER. Well, that was a thought put forward in terms of the competitive situation between mutual funds and banks and thrifts. I remember discussing this at great length with Senator Garn during that period. What I would say now, given the situation that exists, the logical approach, so far as reserve requirements are concerned, to equalize competitive conditions would be to pay interest on the reserves that we require by law that the banks and thrifts hold in the Federal Reserve. That is a kind of tax. It's been there for a long time; it's a more significant tax than it used to be because interest rates are higher. And it does create an entirely artificial competitive impediment to banks and thrifts in competing with money market funds. The only argument for not removing that that I know of is, obviously, like other things, it costs some budgetary money.

But it is an artificial, in my judgment, impediment on the ability of banks and thrifts to compete. So I would urge, among all the other demands upon you, that you consider that at some time. I urge that you and permit the payment of interest on reserve balances that are held there simply because it is required by law.

Senator CRANSTON. Thank you very much.

The CHAIRMAN. Senator Kassebaum.

Senator KASSEBAUM. Chairman Volcker, you mentioned in your testimony that we should look at the insurance system, and you said that there should be effective means of limiting growth and growth of brokered deposits if, indeed, such deposits should be permitted at all. I think you have raised this concern in the past, and I am sure that I remember in 1983, when I believe the FDIC and the Bank Board both raised this question and were greeted with a hailstorm of protest at the time.

Mr. VOLCKER. Right.

BROKERED DEPOSITS

Senator KASSEBAUM. This concerns me as well. While I am not sure we could prohibit brokered deposits, we can certainly say that they should not be insured. Is this something we should do at this point?

Mr. VOLCKER. Yes. I certainly think it is something you should look at. And I don't know whether the administration proposal is silent on that subject or not. I haven't seen anything explicitly on it. But we had this debate 5 years ago, as you mention, and in the end, nothing was done, nothing effective was done. I don't think there is any question that, from this vantage point, the brokered deposit mechanism provided the means by which some of the most aggressive institutions—those that were doing basically self-dealing, the ones that were in many cases involved in fraudulent or near fraudulent activities of the kind that some concern was expressed about earlier this morning—were supported by the ready availability of brokered funds. And given the cost to all of us that this situation has now involved, I think it demands another look.

Senator KASSEBAUM. There are those who argue that it is important in providing liquidity in healthy institutions. Is that a valid argument?

Mr. VOLCKER. Well, I am sure that healthy institutions can use brokered deposits, and it is a convenience to them.

Senator KASSEBAUM. If they are healthy, then they shouldn't be insured.

Mr. VOLCKER. That is not, in my mind, a sufficient enough reason to bless any and all uses of brokered deposits. I make a comment about it in my statement. I was conscious when I wrote it, it sounds easier to deal with than I know, in fact, it is. When you have to sit down and write the regulation and write the law, you have to decide what legitimate uses are there, what are not, when is a deposit brokered, when is it not brokered, exactly how you define it. But I do think it is not impossible to find a solution that is more satisfactory than what has been going on.

Senator **Kassebaum**. Should there be a distinction made, say, between corporate brokered accounts and an individual deposit?

Mr. **Volcker**. Well, I don't see why, offhand. Some of this would be taken care of by some reforms that some people have proposed for the insurance system, which I would say you ought to defer and look at very carefully. But if you limited the amount, a total amount of insured deposits that an individual or a corporation could hold, whatever institution it was in, you have, by that device, I think, dealt with the problem. That may not be a practical proposal, but it may be something that you want to look at in the fullness of time. I don't think you can do it right now.

Senator **Kassebaum**. One other aspect that I believe was addressed by President Bush was not covering extended powers that had been granted under the State charters. I believe President Bush addressed that; did he not?

The **Chairman**. Well, not explicitly, I would say, at least not so far as I am aware.

Senator **Kassebaum**. But I think again, you've raised that, Mr. Chairman, it would seem to me this is something that, as we look at it, perhaps should be certainly reinforced.

Mr. **Volcker**. Oh, I very much agree with that, and I mention it in my statement. I would just make one comment. My understanding of the administration proposals, which I may not fully understand, is that they may implicitly take care of the problem by the authority to the FDIC to withdraw insurance if, in the FDIC's judgment, the powers provided, let's say, by a State authority, are excessive and inconsistent with safety and soundness considerations. But I did not read any explicit directive to the FDIC with respect to State powers. And I think that is one thing you want to debate.

Senator **Kassebaum**. Thank you very much, Chairman Volcker.

The **Chairman**. Thank you, Senator Kassebaum. Senator Bryan.

Senator **Bryan**. Thank you, Mr. Chairman.

IMPACT ON INTERNATIONAL FINANCIAL MARKETS

Mr. Volcker, the chairman questioned you about your preferences, as I read it, in your prepared testimony, and as I understood your comments to us this morning to indicate a more direct rather than an indirect approach which you characterized, to use your language, as financial engineering. And the chairman was questioning as to what impact this might have on international financial markets, their level of sophistication and how they might read this. The Treasury has made a strong argument that if we craft out an exception to the Gramm-Rudman ceiling that this would create a financial chaos or serious dislocation in the international financial markets. And I'd like to get your reaction to that comment.

Mr. **Volcker**. Well, I don't know how I should react, Senator. You have the world's leading expert on the Gramm-Rudman legislation sitting in front of me, and maybe the question ought to be directed to him.

Senator **Gramm**. I would react negatively.

Mr. **Volcker**. To exempting it from Gramm-Rudman. The expense is making an exemption from normal financial practices. That is on the other side, so it is not a one-sided proposition.

Senator **Bryan**. No. And my question was the reaction, in your judgment, as to whether or not this would have serious adverse consequences in terms of the international perception of this exception on an ad hoc basis. At least that's what I understand you're suggesting——

Mr. **Volcker**. Let me give you this answer. It is a difficult area. I think we are running that risk only for one reason, that there is underlying concern about the budgetary situation to start with. If there was not that concern about the basic trend of the budget, I don't think this would be a terribly difficult matter, in my judgment. When you have the underlying uncertainty to start with, as to whether budgetary policy is appropriate—and I think that uncertainty unquestionably is there—then you load this great jab in the trend on top of it, yes, I do think you have a problem. But the problem fundamentally grows out of the basic budgetary situation.

Senator **Bryan**. You have declined to quantify the dollar amount that may be involved here in bailing out these institutions. You have, however, expressed, as I understand it, a preference again for a direct rather than indirect bailout methodology on the basis that that would be least costly, ultimately, to the taxpayers.

My question to you, although you can't quantify in terms of gross dollars what that might be, can you quantify in percentages what the additional cost may be by the indirect as opposed to the opposed to the more direct approach?

Mr. **Volcker**. Well, I think that is a question of the premium on the interest that would have to be paid on the indirect, which I would not think is terribly large. What I had in mind in my statement—the cost of failing to face up to this problem directly—was the bleeding that goes on in these associations when they are not closed up and the situation isn't dealt with effectively that bleeding has been happening in the past year or 2 years.

The administration plan, as I understand it, directly does meet that requirement of getting cash into the hands of the authorities so that the basic underlying situation can be taken care of expeditiously. And I think that is where the point of emphasis should be, whether you do it by Treasury borrowing or whether you do it by this roundabout way. Either way gets the cash to the point of need, which is the most important cost factor at the moment. We should stop these institutions dissipating month by month additional billions of dollars that eventually the taxpayer and the Government is going to have to pick up.

Senator **Bryan**. Conceding that that might be the priority as you have indicated, is there ultimately a cost differential to the American taxpayers by using the more indirect approach as opposed to the direct Treasury borrowing approach.

Mr. **Volcker**. Well, there is some additional cost in borrowing, which I would think is relatively small if, in effect, a strong guarantee is provided, which I assume is what they are going to do.

Whether that cost is borne by the taxpayer or out of higher insurance charges is, of course, a little obscure in the end.

Senator BRYAN. You have raised the point and Senator Kassebaum asked you about the State-chartered excesses. And the question I have to you, do you think we ought to continue with the dual-chartering concept or are you satisfied that there is some method to restrain the wide-ranging power that some States accord to State-chartered institutions?

Mr. VOLCKER. Well, when I look at recent experience, I think that is a relevant question. I don't think there is any doubt that some States went overboard in authorities that they provided to savings and loans. In particular, some States said they could do virtually anything. And it was the Federal Government, via the FSLIC, that was left holding the bag when they could do anything.

I still would like to think that there is a role for the dual banking system and there is some room for experimentation and for new initiatives, but I don't see any reason, given the Federal insurance system, that those new initiatives shouldn't be confined to areas that don't present very large risks for the insurance fund. There is a great controversy that this committee has wrestled with as to whether real estate brokerage, let's say, should be permitted to these institutions. That does not, in my judgment, provide any substantial financial risk. If the States want to take an initiative and the Federal Government hasn't acted, that seems to me perfectly appropriate and desirable. You could say the same thing about insurance brokerage and a lot of other areas that don't present a financial risk.

I have a problem when a State says you can put all your money in real estate development, which I think demonstrably is filled with temptations for self-dealing, for fraud, is inherently very risky, is not the kind of activity, in my judgment, that should be backed by a Federal insurance system or probably any kind of insurance system.

So I think you have to draw a distinction between what kind of powers you are talking about.

Senator BRYAN. Thank you, Mr. Volcker. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Gramm.

Senator GRAMM. Thank you, Mr. Chairman.

Chairman Volcker, let me outline my thinking on this whole question of how we structure the refooting of the savings and loan industry and why, I think, given the options that are available, that the President has probably chosen the right option, and get your response to it.

First of all, as I see it, there are inherent advantages and disadvantages to almost any way you go. But I think that there is a significant advantage to the approach which is basically to say that when there is a Treasury outlay, then it is on budget and counts toward the deficit, that when there is a cash flow, then that is on budget and counts toward the deficit, but that when FSLIC or FDIC/thrift versus FDIC/bank borrow money, then that is not an outlay of the Federal Government. Now I want to be sure we don't get the two insurance funds confused, since merging the two funds would be like me wanting to merge my assets with Chairman

Riegle, when I'm poor and he's rich; it would be theft. We have followed this procedure before. If you go back, I guess the most recent example is in the Farm Credit bailout. What we did there was that the Federal buydown of the interest rate counted as an outlay of the Treasury and was scored as an outlay, whereas the loan was not scored. Now if that loan is not paid back, and the Federal taxpayer has to come in and assume this contingency liability position, that would at that point be an outlay.

Let me tell you why I support that rather than going the other direction of bringing the whole thing on budget and having a direct outlay from the Treasury for the whole program. My view is that the public is inherently suspicious of the Congress, for good reason, about whether or not we are going to meet the deficit reduction targets we set out in law. Even if you could convince people that this represented a once and for all time kind of action, I think you would have the additional problem that it would become a rider for potentially a lot of other changes in the law. I am sort of like the guy working on the levee during the flood when the river is reaching its peak, I don't want to come in and start rearranging the sandbags.

What is your reaction to that?

Mr. **Volcker**. I guess my reaction is that you are to some degree rearranging them anyway, and it is just a question of which is the most expeditious way and effective way and which has least adverse precedents over time. I am not entirely convinced by the principle you were trying to lay down that if the FSLIC borrows it is off budget, and if the Treasury borrows, it is on budget. The FSLIC is a government agency. The securities, I understand—I am not sure how they are to structure this—are going to be, in effect, guaranteed by the Treasury. So the distinction between that and Treasury borrowing, conceptually, gets pretty thin. I would approach it from the other end. I think, in either case it is probably wrong to think of it as a budgetary expenditure analogous to ordinary budgetary expenditures.

I can understand your concern about the precedent of removing it from Gramm-Rudman. This will be an excuse, an unjustified excuse, for exempting other things. I guess I worry a little bit about other programs of the Federal Government that could also be financed in the way that this proposal is set out—ordinary programs of the Federal Government. Just take this program itself. If they overborrow, by the reasoning used, I think it would be a Federal Government receipt. That would certainly be a distortion. You borrow the money to create a receipt.

Senator **Gramm**. Well, there is no doubt about the fact.

Mr. **Volcker**. A net receipt. But how do you stop that? You know, there is room for gimmickry on both sides. I don't know how I resolve the issue as to which way is more efficacious in the end. I do support the idea that in either event, it is not reasonable to think of this as a budgetary expenditure of the type that has to be offset by revenues, so far as the capital value of that security is involved. You are going to get into the interest rate question in any event. And I think that is economically the right way to look at it. The rest of it, we are talking about a kind of accounting and psychological issue.

Senator **Gramm**. So you are saying economically, that it doesn't matter because you are viewing it as being a different, special situation, and it is really a matter of preference as to how you want to treat it.

Mr. **Volcker**. That is right.

Senator **Gramm**. Let me try to get in one question before the light turns red.

WRITING SAFETY AND SOUNDNESS INTO THE LAW

I think all of us are concerned about safety and soundness, and one of the reasons it is appealing to me to have the FDIC come in as the regulator, bringing over the people and the resources of FSLIC that do have some expertise that FDIC doesn't, is because, historically, the FDIC has performed fairly well.

How far do you think we ought to go in trying to write safety and soundness into the law rather than allowing the regulators to set out the principle? Since, let's admit it, that while we still have a dual banking system and while we still have State-granted powers, if FDIC doesn't grant you insurance or they come jerk your sticker off the window, then if you are not out of business, you are going to be greatly hurt.

Mr. **Volcker**. Well, my own feeling on that, and it is a philosophical point, is that in some cases you do want to write the safety and soundness into law, in your terms. We have got problems in the banking system. The FDIC now has authority to remove insurance in a more cumbersome way, and that authority should be improved. They haven't done that, or at least done it extremely rarely, for obvious reasons. All agencies will be under pressures of various sorts. It can be pressures from the industry, pressures from the Congress, pressures from the markets, that will make them shrink sometimes from taking action that—at least in the light of hindsight—often should have been taken. It may not be for any nefarious reason.

I think in cases where the risks are large enough—that is a matter of judgment—and where the authorities are incompatible enough with prudent operation of an insured depository institution, the balance of considerations should be to prohibit the activity by law.

Let me give you an example that I think everybody accepts by long usage. There is a restriction on a bank lending to one customer more than X percent of capital. It is a very arbitrary restriction. Why has 9 percent been OK for 100 years and 11 percent wrong? You can argue it is perfectly reasonable for a small bank to lend more than 10 percent of its capital to General Motors. It is one of the safest loans it can make. That is, obviously, true. At the same time, there is the long-embedded principle that diversification is a good thing. This may be, in some ways, a very arbitrary way to get diversification, but I think that the very strict legislative rule has served us well through the years. I feel the same way about the area, let's say, of real estate development that I just mentioned. There is a question of basic compatibility with a depository institution, even though I am perfectly aware that thousands of banks or savings and loans may conduct that activity in a conservative, prudent, worthwhile manner. My problem is that the potential for abuse, and, indeed, the potential for fraud, is so great that at some point you have to draw the line, even though you are arbitrary in doing it.

The **CHAIRMAN**. Thank you. Before yielding to Senator Graham for his question period, let me just acknowledge Senator Kerry. Did you have an opening comment, Senator Kerry?

Senator **KERRY**. No.

The **CHAIRMAN**. Senator Graham.

Senator **GRAHAM**. Thank you, Mr. Chairman. I think there is one important principle that needs to be underscored and that is that the U.S. Government is going to meet its obligation to the citizens of this country who have placed their confidence in the insurance programs, and that we are talking about the means of achieving that commitment, but the commitment is solid and that the depositors today or in the future can place their faith in the Government's deposit insurance program.

I say that because there has been some evidence, particularly in the last few days of withdrawals from insured institutions, based on apprehension, which are unnecessary.

INSTITUTIONS ON THE EDGE

Mr. Chairman, the question that I would like to return to, as I mentioned in my opening statement, is the sliding institutions, which I would define as those having below the standard capitalization characterized by a recurrent series of losses, declining capitalization. What do you think we should do about that set of institutions in order to increase the likelihood that they will not slip into insolvency?

Mr. **VOLCKER**. Well, I think perhaps the most important thing you can do is implicit in the administration's program and what you have been debating. Let's get some of these really insolvent institutions, some of the weakest institutions, out of the way as quickly as we can. The competitive practices of those institutions on the deposit side and to some degree on the lending side, have aggravated the problems for the marginal institutions by forcing them to pay higher amounts for money and by competing with them in loan markets. So the single most important and constructive thing you can do for marginal S&L's and for banks as well is cauterize that very problem. The administration program is aimed at that. Otherwise, I think some of the regulatory and supervisory pieces of that program are, of course, directed at existing functioning institutions, strong and weak, but they are more relevant for the weak ones. If they are engaging in some practices of exceptional risk, they ought to be brought under better surveillance, and I think that is consistent with what has been proposed here.

If the implication of your question, in part, is that some of those weaker institutions are on a kind of a slippery slope at this stage and will probably move into insolvency, I think that is right. That will be the case for some of them and that has to be taken into account, in terms of estimates of the cost and magnitude of the problem overall. I don't know how big that is, but you can be certain there are a number of weak institutions that, if one closely examined them and valued their assets, would be book solvent now—if one put a realistic appraisal on the value of their assets, they probably would be insolvent today.

Let's take care of the worse ones, get them out of the competitive situation, so to speak—the abnormal competitive situation—relieve those pressures, and then those other marginal institutions are going to have to be dealt with. Many of them will survive; some of them won't. They should not involve the kind of cost that these most serious ones have involved. You know, the cost in some of these institutions has just been enormous, relative to the size of the institution. For the kind you are talking about, the cost should be relatively small.

Senator **Graham**. Well, for instance, you mentioned the desirability of restricting and possibly prohibiting brokered deposits. That has been one of the means by which some of the institutions that are currently insolvent got into such trouble, and they are one of the means that the sliding institutions have used. Another is the issue that apparently today the regulatory agencies cannot take intervention until the capitalization has reached zero.

Should they not be able to intervene at a point before morbidity to begin to take some remedial action?

Mr. **Volcker**. Well, that is an interesting question. In general, I am very sympathetic to providing that authority, but it does raise very difficult issues as to when you can appropriately authorize an administrative agency acting on the basis of its judgment to, in effect, take control of private property.

Senator **Graham**. But I am distinguishing between the insurance function and the regulatory function. You made an issue of where you can intervene as a regulator, but as an insurer, there should be some margin of safety before the institution is down to zero capital, before you can take action.

Mr. **Volcker**. Well, I don't know what the detailed proposals will be by the administration, but I guess, in substance, they are moving in the direction that you are suggesting by providing more authority to the FDIC to remove insurance. How they will handle that particular issue that you raise, I just don't know.

Senator **Graham**. Another suggestion, since many institutions are probably going to have to shrink in size in order to meet the new capitalization requirements, that is, they will not be able to attract new capital, so they've got to reduce the institution, so that their existing capital is at the requisite percentage.

Would it be appropriate now to begin to put some restraints on the sliding institutions's ability to add new depositors in order to recognize the reality of what they are going to have to do eventually anyway and restrict the vulnerability of the insurance fund?

Mr. **Volcker**. I guess it would depend upon a case by case look at those institutions. If some of those institutions are in a weak position, have some bad loans and are out there aggressively bidding for brokered deposits, I would get very suspicious, and yes, it might be quite appropriate to put limitations on their ability to grow.

The **Chairman**. Thank you very much. Senator Mack.

Senator **Mack**. Thank you, Mr. Chairman.

COST OF THE INSURANCE PREMIUM

Again, Mr. Volcker, I would like to go back to the comments that I made earlier with respect to the cost of the insurance premium, in a sense, building on Senator Graham's comments about those institutions that, as you referred to, being on the slippery slope.

Will going from this 20.8 basis points to 23 basis points—is that going to, in effect, force a larger number of institutions into the insolvent category, and if so, should we maybe be talking about identifying those institutions and treating them differently during this period of time?

Mr. **Volcker**. Well, that change is small—two basis points. Sure, in an industry of however many thousand institutions there are, you may find some that any increase puts them over the margin, but it isn't going to be very many. I would think that a larger question with respect to thrifts arises from the fact that that premium is already pretty high, and how long does one contemplate keeping that premium in force? How does that affect the ability of the industry, generally, to raise capital and be a viable competitor over time? To what degree does it discourage potential buyers or to what degree does it discourage current owners from operating in that industry because of the size of the cost burden extended indefinitely over a period of time?

Senator **Mack**. Well, as I understand the proposal, the premium at that 23 basis points is for a three-year period, and then I think it would be reduced to 18, I think.

Mr. **Volcker**. Then it goes down to 18 basis points, as I understand it. I don't know what the implication is for how long that 18 basis points remains in effect.

All I am saying is, I think you are getting near the margin of what is compatible with a healthy savings and loan industry down the road. This issue was debated a couple of years ago, and you provided the authority for FICO. A pragmatic agreement was reached to go up to the 20 basis points and keep that in effect as long as 5 years but not permanently. I thought that was a reasonable, pragmatic judgment by the Congress and the administration at that time. This does not depart from that very much, except I guess it opens up the vision of it lasting a much longer period of time, which is a problem. I don't know just what the administration says in terms of the longevity of the special premium.

Senator **Mack**. Again, I think the proposal was for 3 years, and then it drops after that.

Mr. **Volcker**. Well, it drops to the 18 after 3 years, but I don't know how long the 18 is contemplated staying in effect.

Senator **Mack**. Earlier, you had mentioned feeling that, you know, we do have problems within the banking side of this as well. Are you comfortable, or do you believe that the premium that is being suggested on the banking industry is something that is justified on its own? In other words, separating it from the FSLIC problem, I mean, is it a prudent thing to be doing at this time anyway?

Mr. **Volcker**. Well, I think it is reasonable, in the light of the problems in the banking system and the current drains on the FDIC fund, to review the premium anyway. By saying review, I would contemplate the possibility that, as I said in my statement, the premium might go up some. Again, it is a question of how much and how long. At some point, if it requires a very large premium increase, you wonder what else is the matter. Are the institutions being supervised or regulated correctly, because there really shouldn't be that much risk? It becomes self-defeating if you keep raising the insurance premiums to the point that it affects the competitive position of the industry. Then you haven't achieved anything either.

Now where that margin is, I don't know, but I'm not able to say that the particular proposal of the administration is excessive. Again, I would hope it doesn't have to stay in effect forever, but the savings and loans are already somewhat higher than what is being proposed, at least temporarily, for the banks. I wish it wasn't necessary, but I can't sit here and say that that is an amount that is going to break the camel's back.

Senator MACK. Getting back to the capital side of this thing for a minute, again, the President's proposal calls for doubling the capital, if you will, in the savings and loan industry by 1991. Is that feasible to do that?

Mr. VOLCKER. Well, it is going to be quite a challenge, because it runs against the very point I was mentioning earlier. If you make the insurance charge or other problems too difficult, it makes it that much harder to raise the capital. I am not familiar with the calculations as to how much capital it takes, but I am sure that one has to—if one wants an independent savings and loan industry—make sure that the industry is reasonably attractive, or you are not going to get any new capital. The brightest thing in the savings and loan industry, the thing I keep coming back to in my own mind, is my impression that the most successful and profitable institutions currently are those that followed, basically, traditional savings and loan patterns. They are heavily concentrated on home mortgage lending. To the extent they have extended their activities, it is still within the framework of kind of a family oriented deposit business. They have done quite well, many of them, in terms of profitability. Some of those large institutions are as profitable or more profitable than most of the comparable commercial banks.

So I think there is a future for the industry, and I think there is a future for the industry in a kind of traditional mode. But you can't, obviously, load too many penalties from the past history of other institutions on the viable institutions.

Senator MACK. Mr. Chairman, if I could ask just one more question.

The CHAIRMAN. You may. And I hope we can do it quickly. I think that was a very important statement that Mr. Volcker just made.

Senator MACK. It has to do with, again, placing the Federal Home Loan Bank System under Treasury and whether there is another alternative. For example, how about the Federal Reserve?

Mr. VOLCKER. Well, this question came up in your absence in colloquy with Senator Garn, when he expressed some preference for a somewhat independent body or an independent body. That is my instinct, entirely apart from this problem. I would think that in an area of banking regulation, as in some other regulatory areas, there is a lot to be said for autonomy by the regulatory agency, and having a board rather than all the responsibility concentrated on one inevitably fallible human being, however able he may be.

So administratively, I would have a different preference than the one expressed by the administration, but I do agree with what I consider the more basic recommendation about removing the insurance system from its close relationship with the Home Loan Bank Board, however it is constructed. I would like a degree of independence, but if you want a channel of some influence from the Treasury or from the Federal Reserve to a reconstructed Home Loan Bank Board, I think that might be desirable. I think the Federal Reserve does have a real role to play in this kind of thing as a— well, I am prejudiced from the standpoint of the Federal Reserve, but I do think it has an important role and brings something to the party in all these cases.

Senator MACK. Thank you.

The CHAIRMAN. Thank you. The Chairman of the Budget Committee, Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Mr. Volcker, I want to go back to something my colleagues have already touched on, and that is the question of the relationship of Gramm-Rudman-Hollings to this whole question of the FSLIC proposal here.

FINANCING ON BUDGET BY THE TREASURY

How much would be saved by the taxpayers by financing this whole thing directly on budget by the Treasury? Could you estimate that? I know this is a very difficult question.

Mr. VOLCKER. No, I think it is almost impossible without knowing in more detail the precise terms and provisions that they would develop to protect the new securities. I assume that they are going to provide strong protection, but I am just at a loss, because I haven't had enough time to study the proposal. I am not sure that these details are out. If the Treasury is, in effect, guaranteeing the interest, and they have security for the principal, I would not think the extra premium paid on the interest rate on the security under those conditions would be very great. The principal isn't worth much when you put it out 30 years, 40 years. What is important is guaranteeing the interest. And there are a lot of these securities, potentially, so it is not going to be an odd market. Now if there is some doubt about the guarantee, then you have a different story.

Senator SASSER. Yes. Right.

Mr. Volcker, this whole FSLIC bailout proposal is very sensitive to interest rates. The proposal, as I understand it, is based on the same rosy interest rate assumptions that were in President Reagan's budget, and his rates are now about 2 percent below what the current market rates are.

I fear that if interest rates go higher, significantly higher, we are going to see another avalanche of S&L's that will go bankrupt. Now in today's financial markets, we have the unusual situation called the inverted yield curve where short-term rates exceed long-term rates. And a distinguished economist such as yourself knows what that means. The so-called "inverted yield curve" happens, I am told, very, very infrequently, and when it does, I am also told that you can generally count on a recession following it.

Is that the case?

Mr. **Volcker**. Well, it tends to happen when money is relatively tight and business is very strong, and to some degree, you have that situation now. Sometimes tight money periods have been followed by recessions.

Senator **Sasser**. Well, if that is the case, and we've got the problem of these S&L's hanging out there very sensitive to interest rate run ups, and we have this inverted curve staring us in the face, isn't the Federal Reserve going to have to ease up on monetary policy fairly soon?

Mr. **Volcker**. Well, I don't want to comment on the Federal Reserve policy.

Senator **Sasser**. That is why I am asking you.

Mr. **Volcker**. I assiduously avoid commenting on Federal Reserve policy. You have a very able representative of the Federal Reserve, its leader, Chairman Greenspan, coming up to testify before you fairly shortly, I think, and he's been making very wise comments, it seems to me, in public and otherwise. But let me say this: If you are worried about that kind of thing, and you ought to be worried about it—not the Federal Reserve tightening but whether interest rates go up and all the rest—the basic problem is not what we are talking about here and just how we account for that whatever it is going to cost the Government to deal with the savings and loan problem, it is rather that we continue to have, in my judgment, an underlying budgetary problem, as I alluded to earlier. And if you are going to relieve that problem, the remedy seems to me self-evident. We keep dancing around this issue. You ought to be dealing with that, as a Congress and as an administration, alongside this savings and loan problem, which is not, in that sense, a basic economic problem, although it is going to cost a lot of money. It is not a basic budgetary problem anyway, in my opinion, even though it appears that way on the surface.

Are we convinced that we are on a basic underlying track toward balance and surplus? I don't think the market is convinced of that, and they have had quite a lot of evidence in recent years that I think raises legitimate questions about it. You are going to have to come up with a budgetary program one way or another that is convincing in that respect. If you are, I think the kind of interest rate problems that you are talking about, and the ease of managing this whole savings and loan situation, will be greatly facilitated. I would not worry so much, as I said earlier, about how the markets, whether they are domestic markets or foreign markets, are going to take this extra financing necessary to deal with the savings and loan situation if they were convinced it really is an extraordinary situation, whether you do it by one device or another device.

If they think that that is an aberration in a satisfactory, prudent trend, it won't be much of a problem. If it simply reinforces doubts about the underlying trend, you have got an entirely different situation.

Senator **Sasser**. Thank you. My time has expired.

The **Chairman**. Senator Pressler.

Senator **Pressler**. Thank you very much, Mr. Chairman.

Let me ask you just a few questions that apply maybe to the smaller banks and smaller thrifts. Next week I am going to be in my home State of South Dakota. I am having 16 town meetings over a period of 5 days. But in any case, we in South Dakota have not experienced failures of thrifts as elsewhere in the country. They have been in that category you described earlier of small depositors and loaning the money for housing and so forth.

No doubt—I anticipate being asked by some of them, are we being asked to pay for the sins of the big thrifts and those who took risks in real estate development and so forth.

How can I answer that?

Mr. **Volcker**. Well, I think they are, to some degree but not entirely. I think the only answer you have is that they were part of an industry, and to some degree, all the members of the industry were in this thing together. There was an implied or explicit contract that you will first look to the industry itself to take care of these costs. I would hope the net result of that is to reinforce the determination of conservatively operated savings and loans—and the kind you have in the Dakotas—to take an interest in and be supportive of regulatory and supervisory measures to rein in the outliers.

Senator **Pressler**. In other words, when the bankers ask for more deregulation, I should say this is an example for saying no.

Mr. **Volcker**. I think that depends on what type of deregulation. Some is fine and some is not. And I think you have to make that distinction. It gets complicated. But yes, I think in cases where it would undermine clearly safety and soundness, they ought to have an incentive to say no, because in the end, it is going to cost them money.

ADDING TO THE NATIONAL DEBT

Senator **Pressler**. I am sure I will be asked the basic question: Does this add to the national debt?

I know we have talked this morning about whether it goes on Gramm-Rudman or how it is treated—on budget, off budget. What is the basic answer to that?

Mr. **Volcker**. Well, I think the basic point is, yes, it adds to the national debt.

Senator **Pressler**. It adds $30 billion or whatever the amount may be?

Mr. **Volcker**. Whatever the amount of billion is. It either adds to it in the form of Treasury debt or it adds to it in the form of a guarantee of the interest.

Senator **Pressler**. Is there anything about the competition factor——

Mr. **Volcker**. It may not add—just to be clear—to the Treasury debt as routinely, the national debt you ordinarily think of as Treasury tabulated debt. It may not technically be Treasury debt, but in a larger sense, it is going to be an obligation of the U.S. Government.

Senator **Pressler**. Yes. I know we have these great debates inside the Beltway whether something is on budget or off budget, whether it is under Gramm-Rudman or it isn't under Gramm-

Rudman. So I think that should be basically understood that it does add to the national debt.

Is there anything unique in your mind about small banks or small thrifts where you really don't have competition in the same way? I mean we discuss this as though competitive conditions are relatively uniform even if it is a small thrift in a large city, you can go to another small thrift. But most of the customers of the small banks and small thrifts are captive customers, so to speak. That is the only place they know about unless they are going to drive to another city, and they probably wouldn't do that.

Will this plan fall unduly hard on those smaller banks and thrifts that have captive customers, so to speak?

Mr. **Volcker**. Well, if they really had captive customers—I don't think there are very many that have entirely captive customers, when you can do banking in money market funds by mail or bank in another bank by mail—but to the extent they are somewhat shielded from competition, obviously, it hurts less. Those banks will find it easier to accommodate to the higher insurance premiums.

Senator **Pressler**. So overall, you are supportive of this plan and——

Mr. **Volcker**. Yes, I am delighted that they moved so quickly to present a plan of broadly appropriate scope, although I have, obviously, questions about some of the details and some of them aren't very explicit in the plan as I know it now.

Senator **Pressler**. Thank you very much, Mr. Chairman.

The **Chairman**. Thank you. Senator Sarbanes.

Senator **Sarbanes**. Thank you very much, Mr. Chairman.

Chairman Volcker, let me say, first of all, I am having to go through an adjustment process here this morning while looking at you without having a huge sort of wreath of smoke from a cigar surrounding you. It is a new experience for us.

Mr. **Volcker**. Fresh air.

Senator **Sarbanes**. Have you given up smoking? [Laughter.]

I am just curious.

Mr. **Volcker**. I have given up smoking. I have joined that great band of nonsmokers for sometime now.

Senator **Sarbanes**. Congratulations.

Mr. **Volcker**. For 22 months and 7 days. [Laughter.]

The **Chairman**. And 36 minutes. [Laughter.]

Senator **Sarbanes**. Let me just put a few questions to you. First of all, why should Federal Government insurance of deposits be extended to institutions that are State-chartered, who are given broadened powers beyond those judged to be appropriate for Federally chartered institutions?

FEDERAL GOVERNMENT INSURANCE AND STATE CHARTERED INSTITUTIONS

Mr. **Volcker**. Again, I would say it depends upon what powers. I think it should not be, if those powers clearly fall into a category that is deemed to be unduly risky relative to the powers provided by the federally chartered institutions. And of course, the federally chartered institutions shouldn't have unduly risky powers either, but that is a bench line. We touched upon this earlier, but I can certainly contemplate, and it may be a good thing, that the States have authority to provide additional powers where there is no substantial interaction with excessive risk. And there are lots of those powers that have been very controversial, as you know, before this committee.

Senator **Sarbanes**. Who should make that judgment?

Mr. **Volcker**. I would, I think, prefer that it be made by a combination of legislative direction and some residual authority, let's say, by the FDIC, if it is tied into insurance. And I say a combination, because I would think there might be some areas that are deemed sufficiently beyond the pale that an arbitrary line—at the margin, an arbitrary line—ought to be drawn and say no. There may be other authorities for which the details could be left to an agency. Take lending on commercial real estate, which is an area that has been the source of enormous difficulty. It is pretty hard to say an S&L can't do any lending on commercial real estate, and I wouldn't propose that. And it is pretty hard to say just what terms and conditions are appropriate. That is a kind of more subtle judgment. I can imagine that some States and State supervisory authorities might be so liberal in terms of commercial real estate lending that it poses a palpable risk to the institution and to the insurance fund. Then, the FDIC could come along and make a judgment and say, look, standards for real estate lending at the minimum have to be X, Y, Z. It is very hard to legislate in that area.

Senator **Sarbanes**. Well, your point about arbitrary limits serving a purpose, I think, is well-taken. Otherwise, you get on the slippery slope. I mean, it is quite true, as you said, you know, there is no magic between 9 percent and 11 percent, but if that is the case, then, you know, you give 11 percent, and then there is no magic between 11 and 13 percent, and on and on you go. I think that's probably one of the problems of leaving it at the State levels, there is always the competition between States to be more attractive and therefore to have easier restraint. I think that is one of the things that has to be addressed.

Mr. **Volcker**. There is a tension, just to amplify your point, between the competition among States, and the lack of responsibility for the insurance system.

Senator **Sarbanes**. It is a free ride.

Mr. **Volcker**. Yes.

Senator **Sarbanes**. You spent a lot of time this morning addressing questions about how this should be structured, on budget or off budget.

As I understand it, there is a significant difference in cost between structuring it one way and the other. Do you understand that to be the case?

Mr. **Volcker**. Well, I think there will probably be a difference, because securities that are not labeled Treasury securities, even though they are guaranteed by the Government one way or another, usually trade at higher rates. I would expect that that would be true in this instance, but as I said, the differential may not be very large; it will be smaller to the extent that the market perceives and there is a rational basis for seeing these as basically fully guaranteed securities.

Senator **Sarbanes**. But shouldn't that be thrown into the scale in trying to judge this thing? In other words, suppose adhering to Gramm-Rudman, and therefore, taking it off budget, represents a significant additional cost simply for doing it that way. Then don't you have this arbitrary structure in effect imposing further costs, which it is not really necessary to undergo?

Mr. **Volcker**. Well, I also raised some questions about this indirect way of financing, but let me make the argument on the other side. If there is some reason for distinguishing this from ordinary, let's say, deficit financing, and if there is some disciplinary results coming from the higher cost, it may be justified. I do believe, as I tried to make clear, in a fundamental way, I would not consider this extraordinary expenditure for the savings and loans to be parallel to run-of-the-mill—if that term is appropriate—budgetary expenditures. I do not see the special expenditure for this purpose as something that for fiscal policy reasons on has to offset, let's say, by revenues. And that is the fundamental judgment to be made about the budget. I think it will raise interest costs over time and that interest will have to be covered. If the interest is a little higher one way of doing it than another way of doing it, you, to that extent, have aggravated the problem.

So it comes back to whether there is really a good and rational reason for doing it in a way that I guess I would have to concede makes the basic economic point that this is not just like another government expenditure. That is why I would exempt it from Gramm-Rudman, if you did it the other way.

If that is all clear. I am not sure that it is.

The **Chairman**. No, I think it is, and you commented on that earlier in the day, and it is a very important point, and I think it is an important one to illuminate. Senator Sasser raised that earlier as well. Senator Shelby.

IMPACT OF TECHNOLOGICAL CHANGES IN MORTGAGE ORIGINATION BUSINESS

Senator **Shelby**. Thank you, Mr. Chairman. You make mention in your testimony of the impact of technological change on the mortgage origination business. You acknowledge that we are in a different era. By the time the thrift industry is restored to health by the administration's proposal, perhaps 25 to 30 years down the road, will the securitization of mortgages have eliminated the need for a separate thrift industry?

Mr. **Volcker**. Well, even now, I don't think the need in some absolute sense is as great as it was in the 1930's.

Senator **Shelby**. When thrifts first became important in the home mortgage business.

Mr. **Volcker**. Right. And we had an urgent public priority of improving the availability of housing and getting it financed. And it was perceived, I think with reason, that that purpose would be greatly facilitated by a specialized industry. Now that specialized industry inevitably has been overtaken by some basic technological and economic events. A lot of other people supply home mortgages. I, myself, would guess that there could still be room for healthy, vibrant institutions primarily concentrated on home lending, probably making adjustable rate mortgages rather than fixed rate mortgages.

Senator SHELBY. Based on a local savings pool?

Mr. VOLCKER. Based upon local savings patterns of various sorts and based upon other services that would be provided—some of them may be very large institutions, but basically providing consumers or individuals services on a local level.

Senator SHELBY. But how can they compete in the marketplace? Let me post this further. Securitization, basically, has driven the price of the interest rates, in other words, the cost down some. How could X institution, based on local funds, complete in the marketplace?

Mr. VOLCKER. Well, for two reasons. They may be providing a somewhat different product.

Senator SHELBY. All right.

Mr. VOLCKER. They may be providing an adjustable rate product, which is probably not a thing which is so easy to securitize, although it is not impossible. It may not have such a rate advantage if it was securitized. Some of these institutions, by the nature of their operation, if they are run efficiently, will have access to low-cost funds. They don't have to compete in central money markets, because through their services to the local community and through the relationships that they develop, they may, in fact, have quite cheap sources of funds—so called "core deposits," the old savings deposits, money market deposit accounts.

Senator SHELBY. As part of the local savings pool?

Mr. VOLCKER. They may turn out to be relatively cheap. People want to keep their money locally, and they want to be able to go to the institution and get it out and get other services while they are doing it.

Senator SHELBY. Dr. Volcker, do you anticipate or do you see any trouble down the road of the so-called "healthy thrifts" raising additional capital, especially from 3 percent to 6 percent to meet the future, you know, safety standards? It looks to me like that might be tough.

Mr. VOLCKER. Well, I think it is an area of concern. I haven't analyzed the figures closely enough to have much of judgment. If you applied commercial bank capital standards to thrifts as agreed to in this recent compact, and you had no other minimum—I am making a lot of assumptions here—thrift institutions concentrated on home mortgages would get a break on capital requirements, because home mortgages are weighted relatively likely in that calculation. So that would, I think, ease the problem of raising capital for thrift that specialized in home mortgage lending.

Senator SHELBY. But what if the thrift engaged in a broader range of activities, more like a commercial bank?

Mr. VOLCKER. Well, if they are acting like a commercial bank, as I say in my statement, I would treat them like a commercial bank.

Senator SHELBY. It ought to be done.

Mr. VOLCKER. I think it ought to be done. If it looks like a—well, I won't go into that. [Laughter.]

Senator SHELBY. Dr. Volcker, I would like to address the issue of deregulation just a little bit. You mentioned that one of the biggest problems which caused thrifts to fail was that of thrifts dealing in real estate. They engaged in high risk real estate development. What is your opinion about banks getting into real estate activities? Isn't that a dangerous thing?

Mr. VOLCKER. Yes. I would make the same comments about banks. Now banks have not taken risks to anything like the same extent, but it is an issue. I historically have been on the conservative side of that issue, and everything that has happened in the last 2 or 3 years suggests that was the right side of that issue to be on.

Senator SHELBY. Then you believe that there is a lot of difference between a bank engaging in securities activities and a bank perhaps getting involved in self-dealing real estate ventures.

Mr. VOLCKER. Yes. I think there is. I am quite in favor of the kind of thing that this committee was doing last year in the securities area, and you could even go further and there are other areas. There is nothing the matter with real estate brokerage, for instance. But real estate development does get into an area that I think demonstrably has exceptional risk, even though some institutions would handle it very responsibly.

Senator SHELBY. My time has expired. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Let me ask you a related question, and that has to do with the distinction and the separation between banking and commerce. We have talked about this in the past as well. In the savings and loan business today, we are seeing some developments that are appearing to blend the two, commerce and the S&L type of banking. In a couple of the major December deals, you had demonstrably commercial enterprises coming in and picking up a package of thrifts and amalgamating into a broad holding company, a mixture of commerce and banking. In one of those cases, there was even a question of the creation of a merchant bank which raised a new policy question.

We have obviously had a major industrial corporation, Ford Motor Co., come into the savings and loan business doing basically a traditional home lending mortgage type business that you generally recommend. But you have now there a very tangible example of a major industrial corporation that has come into financial services via the savings and loan route.

THE BLENDING OF BANKING AND COMMERCE

As you think about this question, the degree to which banking and commerce should or should not be blended together, what are your current thoughts on that? How do they relate to the way we should look at the S&L issue and how should we look at it in terms of deposit—federally insured deposit institutions, whether they are banks or savings and loans?

Mr. VOLCKER. I think my current thoughts are the same as my thoughts that I have expressed upon a number of other occasions before this committee. I went back and looked up a couple earlier statements I had made in this area of savings and loans. I am not much concerned with business firms or commercial firms buying and operating traditional thrifts, so long as they continue to operate more or less as traditional thrifts. I think there should be, obviously, some limitations on transactions between the parent or other affiliates—business affiliates—and the thrift. But I think they are fairly easy and natural, if indeed the thrift is operating in a traditional manner. You pointed out, Ford owning Nationwide. Well, they have greatly expanded, but my understanding is that it has basically been in that traditional pattern.

The CHAIRMAN. Yes.

Mr. VOLCKER. It is also my understanding with the one that may become a client of ours, McAndrews & Forbes. In connection with a Texas acquisition, where they have asked us to consult with them on the operation of that thrift, the intention is to operate it as a traditional thrift. But there have been other instances, and I do think limitations ought to be put in, just as in the commercial banking industry. If you are running a diversified thrift, the rules ought to be the same as the commercial banks. And that is an important aspect of why I think those industries, in effect, ought to be consolidated, if they are a diversified thrift.

The CHAIRMAN. Are you convinced in your mind that you can, by regulation and firewalls and other devices, prohibitions on self-dealing, prevent a multifaceted holding company from actually reaching across the line?

Mr. VOLCKER. I have never been totally convinced of that. I think that firewalls and restrictions can serve a purpose, and you should have them, but I think you shouldn't rely upon them for solving all problems. The basic dilemma is that if an organization wants all these diversified activities, it presumably wants them under common management. It sees some advantages in having them under common management, or otherwise it wouldn't do it. Ordinarily, they have some synergies between them. If you take away any possibility for any synergy, you won't have many of these combinations. I think it is unrealistic to do so. In extremis, they will try to find a way around the restrictions. That doesn't mean don't have the restrictions. It just says, if the activity appears out of keeping with the character of a depositary institution, you better get arbitrary and say no, as I have said many times to this committee, for large combinations of general business and banking. That doesn't mean the bank holding companies can't engage in a big range of financial activities, including some that they are prohibited from engaging in now. While I understand it, providing these security powers through these interpretations of Glass-Steagall is silly; the decision turns on how much—I can't even remember the magic term any more—becomes primarily involved or substantially involved.

The authority ought to be provided straightforwardly with appropriate safeguards, including what firewalls appear appropriate. I hope you won't get too diverted on the savings and loan problem that you don't get back to that at an early stage, because I think this committee had a very constructive approach toward that question last year.

The CHAIRMAN. Well, we will be getting back to those issues, although we are going to move the savings and loan problem through to conclusion before we take up anything else.

Let me ask you one other thing before yielding.

I am wondering if it would be your judgment that in fixing the savings and loan problem, both the structural reforms and the funding of it, that we should make sure that we should err on the side of going far enough to give us every reasonable assurance that we have solved this problem so that it can't somehow mushroom over the next 2 or 3 years again and come back around and find that all of a sudden, instead of having a $100 billion exposure, that through either miscalculation or wishful thinking, we've let the situation stay in a form where it can, you know, expand on us again.

I am wondering if—and really, my question relates to whether or not, if we should fail to do this properly, and we were to find that this thing were to come back around again in a larger size—that would be the kind of an event that would be very damaging to us, both internally and externally, if we were to miss the opportunity to really fix this problem?

Mr. VOLCKER. Well, I think it obviously would be very damaging, but you have I think a realistic limitation on what you can do in a limited period of time. You have the urgency of getting some cash injected in there in a hurry, whichever route you take. That ought not to be distracting us from the underlying budgetary problem and working on that, but let's get the cash in there and let's get the reforms that seem very clearly needed and can be relatively easily implemented and ought to go some distance toward taking care of the underlying problem.

Those reforms are largely of an administrative nature, of a supervisory nature. I think you should come back and revisit this subject let's say early next year and take a still more fundamental look to see it the insurance system gives such adverse incentives—in the economist's jargon, a "moral hazard"—that you will want to make structural changes in the insurance system itself. I don't think you should neglect that job.

Now my own judgment at this point is that you probably should not and need not make terribly radical changes, but I think you ought to review the subject, including the one particular proposal that I made in my paper which doesn't disturb in any basic sense the insurance coverage.

I think that review would provide you a necessary bit of insurance against exactly the risk that you're talking about. I don't think there's any way you can be absolutely certain you can do it from where are we now—in February—and you want legislation before May. I encourage you to do that. You've got 45 days. I think it's possible to get out a constructive piece of legislation to stop the hemorrhaging, get the cash in there in that kind of time period. But I don't think you can tell yourself that you have done the job so profoundly and so correctly that you have absolute assurance against a recurrence of the problem.

I would want to come back and revisit that and I think the administration is suggesting that, too.

The CHAIRMAN. I think that's excellent advice and my instincts run the same way. I have to tell you that we have had a problem of a severe understaffing of this particular committee over a period of time in relation to other committees in the Senate and we've got major oversight responsibilities. We've had $100 billion disappear in the savings and loan area. We are in the process of making some adjustments to make sure that we've got just the professional staff capability that we need to have to do precisely that—to do the oversight functions on a timely basis to get ahead of these problems. If something is developing or if we've crafted a solution that isn't quite on the mark, that we have an opportunity to spot that early, come back, revisit the issue, make adjustments when they are needed, and I have every intention as the new chairman of this committee to see to it that the oversight job gets done. And I see that as a very material responsibility.

So I appreciate your stressing that and I intend to do exactly what you say.

Senator Sasser.

Senator SASSER. Thank you.

Mr. Chairman, you were discussing a moment ago when my time ran out the overall question of the budget. This question of interest rates and the budget deficit, I must say, is a very perplexing one to me.

For example, in 1986, the deficit expanded dramatically, making 1986 the worst deficit year we had. Yet interest rates fell in 1986. In the following year, 1987, we reached an agreement on deficit reduction up here, and most people think we made some substantial progress on deficit reduction, but at the same time, the interest rates rose.

Now, we're in a situation now where interest rates are rising once again, but the deficit is actually decreasing in relation to both GNP and revenues. This sounds like a speech that ought to be made by Senator Gramm, who I very, very seldom agree with.

Now, I do agree that we need to reduce the deficit. I think this whole question of the overhanging and ever-increasing national debt is a terrible legacy to leave. I think it's eroding the very basis of our economy. It's a corrosive thing.

But, given all the expenditures that the Federal Government makes that are interest sensitive, it would sure be a whole lot easier to get this deficit down in a lower interest rate environment. And it seems that your successor at the Fed is not giving us a lot of cooperation on that point at the present time.

Let's talk about something that you and I do agree on, though.

Mr. VOLCKER. I wish we would agree that Mr. Greenspan is doing a terrific job.

Senator SASSER. Well, I'm not saying he's doing a poor job, Mr. Chairman. I have suggested that I think Chairman Greenspan is overly sensitive to real or imaginary inflationary pressures that frankly some of us don't perceive to be as threatening as Dr. Greenspan and his colleagues at the Fed perceive them to be, at least at the present time.

I'd like to look back historically, if I could, and pick your brain on a matter. You have always, as I understand, been an advocate of a specialized system of housing finance, and in your testimony I note with interest that it appears the largest FSLIC losses have been concentrated in those savings and loan institutions that moved away from home mortgage lending and started exploiting their new powers. Perhaps the most glaring examples are getting in windmill farms, et cetera, but generally they simply got into commercial real estate matters that they didn't know much about.

You make the point that those institutions that concentrated on home mortgages, something with which they were familiar, were able to restore their profitability.

So I guess the question and what I'm trying to learn here from past history is, would you say that the deregulation that started in 1982 in the thrift industry on the asset side was not successful?

Mr. **Volcker**. Well, I think it's hard to make a sweeping judgment and I wouldn't want to make that particular sweeping judgment. I certainly think it was not conducted prudently so far as some States were concerned. It went far beyond anything provided by the Federal Government.

INADEQUATE SUPERVISION UNDER DEREGULATION

I think it is also clearly evident that within the context of what the Federal Government has done the supervisory apparatus at the time was simply not up to the task of providing adequate supervision and restraint in that kind of a relatively deregulated environment. There was not the experience. There was not the manpower. There was not the talent. There was not the administration.

Senator **Sasser**. Mr. Chairman, there have been statements made that at that particular time in history that the Bank Board was requesting additional examiners, additional supervisory personnel, but they were rebuffed by OMB.

In your vantage point at the Fed, do you know whether or not that is accurate and did the Fed weigh in one way or another in that whole controversy, if there was a controversy.

Mr. **Volcker**. Well, there certainly was a controversy and I think that it is broadly accurate that in the case of the Home Loan Bank Board it was subject to restrictions from OMB. They found it difficult to pay the salaries or hire the people that they thought necessary to do supervision. They had inherited at that time a supervisory staff in size and in inclination that wasn't adequate to the job because they used to just regulate home mortgages which shouldn't have much risk and they weren't attuned to the problems of commercial examination.

Yes, I think there was a problem. We in the Federal Reserve at the time—I can't cite chapter and verse on that particular problem—attempted to be supportive of the Home Loan Bank Board. We were certainly explicitly supportive of measures that Chairman Gray tried to take to improve capital standards, to reduce brokered funds and the like. There is testimony and correspondence on the record on that aspect.

Senator **Sasser**. Apparently, the Home Loan Bank Board had the same problem we had here on the Senate Banking Committee and still has to some extent. They were understaffed and couldn't deal sufficiently with the problem and we find that we were apparently understaffed at the same time and were unable to give it the kind of analysis that the problem deserved.

Let me ask you this question, Mr. Chairman. Suppose that we hadn't deregulated the rates on deposits in the S&L's. Suppose that we kept those rates controlled. Do you believe the thrifts could have retained a core of deposits really coming from those persons who valued deposit insurance, valued stability, or not; and would the thrift industry have recovered eventually when interest rates declined later on in the 1980's?

Mr. **Volcker**. Well, that's a very difficult judgment. Would you have allowed some relief within the interest rate ceilings so they could have paid somewhat higher rates on core deposits? Some of those institutions did retain quite a lot of core deposits at rates much below the market rates and rates not much higher than they were when they were regulated.

But even in institutions where that was most true, it would have been a limited fraction of their total deposit base and the institutions would have had to shrink a great deal. Whether that would have left them in a viable position after interest rates came down, some yes, some no, I suppose.

There would have had to be massive lending by the Home Loan Banks and maybe by the Federal Reserve, and whether that would have been possible is another hypothetical circumstance. The answer would depend upon how long it would have lasted.

I don't think it would be viable over a period of time in today's open markets and with the degree of fluctuation in interest rates that we're getting these days, to think of a regulated interest rate environment in the way we had it in the late 1970's and before. It's very hard to think of going back to that, basically because the markets are so much more volatile.

Senator **Sasser**. Thank you.

Mr. Chairman Riegle, I want to thank you for inviting Chairman Volcker here today and I personally am grateful for his attendance. I can't let this opportunity pass without commending Chairman Volcker on his fine work in support of those who go into the public service.

For too long, we've seen the public servants demeaned and not getting the credit that I think they deserve for serving the people of this country well and honorably and many times without adequate recognition. Mr. Volcker has undertaken to give them some recognition and encourage young people to come into the public service and I would like to commend him for that. Thank you.

Mr. **Volcker**. I appreciate that plug, if I may say so, Senator Sasser. The Senator gives me an opportunity to say that you worry about your staff, you referred to the staff at the Home Loan Banks and their restrictions. Who knows to what degree, with stronger professionalism and more professionals in the right places in the Federal Government, we wouldn't be faced with a $100 billion bill currently.

The **Chairman**. Exactly.

Mr. **Volcker**. So we're going to have a report out very shortly and I recommend it to your sympathetic attention.

The **Chairman**. I want to associate myself with Senator Sasser's remarks that he's just made.

I'd like to raise two other questions with you. You've been very patient. I'll be very quick.

If you take home lending, in your view, that is really the central focus of the savings and loan industry. Its central purpose and its traditional historical purpose. I'd like to have you think for a minute. Would you anticipate that as you look at the industry, that home lending and everything related to residential housing finance and so forth should constitute at least 50 percent of the activities of the savings and loan or 60 percent?

Mr. VOLCKER. I think we proposed a higher figure than that when I was in an official responsibility. The figure now is 60 percent I think for some tests, but that allows for some liquidity and allows for something I never quite understood—for mortgage originations when they didn't hold them. I didn't think it was appropriate to make that allowance. If you fix that up, I would think that's in the appropriate range. I always argued for slightly higher.

The CHAIRMAN. Sixty percent?

Mr. VOLCKER. Well, 60 percent including liquidity which wouldn't be very far from your 50 percent.

The CHAIRMAN. Now because of the problem with the States which have gone way beyond what the Federal Government allows, we've got a very odd set of patterns out there. But once you've arrived at a core business which is the home lending mortgage finance business, can you give us any specific thoughts as to what you think are the kinds of appropriate wraparound activities that conceivably should be retained or argued for to fill out the charter of a savings and loan that's going to operate on top of Federal deposit insurance?

Mr. VOLCKER. Well, I would think in general they ought to have the authorities that are natural, to use that word, in serving individuals or families. It should be consumer credit powers, a variety of deposit powers. There's no reason why they can't do a stock brokerage service as commercial banks can now, at least in a passive kind of way. Many of them can do in some States real estate brokerage on homes. I would provide those additional authorities so far as Federal law is concerned.

Some margin of commercial lending, including commercial real estate lending, might be appropriate, but I don't think that should come to be the dominant activity as it's become in some of these institutions, particularly commercial real estate lending. I don't think there is a lot of room for real estate development.

The CHAIRMAN. Are there some things you think ought not to be in there?

Mr. VOLCKER. Well, very large authorities with very liberal lending terms for commercial lending and for real estate development. The way many of these institutions have been operating, it's very difficult to tell the difference between a commercial real estate loan and real estate development. Some of the loans were basically of the developmental character. There wasn't much equity. You were making equity in the guise of a loan.

The CHAIRMAN. How about junk bonds?

Mr. VOLCKER. They can buy junk bonds now and banks can't. If they can do it, it ought to be a pretty small part of their total portfolio and insist upon diversification. I don't know that I would have a religious war about whether they can buy any junk bonds, but I certainly don't think it's appropriate for an insured depository institution to hold a substantial amount of them.

The CHAIRMAN. How about currency trading? I'm just giving you examples of some of the things that——

Mr. VOLCKER. I don't know that currency trading is something I would rule out on legislative grounds. I would think it would be doubtful that a supervisory authority, looking at an ordinary family oriented savings and loan, would find a requisite degree of expertise and a natural market that would justify currency trading. But maybe there would be a rare case. It would have to be closely controlled.

The CHAIRMAN. If you have any further thoughts as to what constitutes sort of the kind of a reasonable bundle of operating authorities with any kind of rough sense on percentage shares and so forth it would be useful for us to hear that from you.

Mr. VOLCKER. I don't think you have to—if I may just add—get very detailed on this subject. If you say so much has to be in home mortgages and you're going to have some liquidity requirements anyway, you have already limited the room for other kinds of asset holdings simply because you don't have any room left. I guess we started out by saying the home mortgages themselves, without the liquidity, ought to be 60 percent back when I was in the Federal Reserve. But you could put limitations together on a number of other activities and say, look, you can do a variety of activities so long in total they don't exceed "x".

The CHAIRMAN. The last thing I want to raise with you and I'll be very quick and I'll ask you for a brief answer. That is, as we talk about this budget situation, we're borrowing and spending the Social Security reserves, and we're doing it every single day. We're borrowing them and spending them on the general operations of government and we're accruing huge bills that the general government owes Social Security for the reserves that we've taken and spent on just the day-in and day-out operations—the defense department, education, what have you.

I am really troubled about that because these reserves are now building up, but just as rapidly as we build them up we're grabbing them and spending them and creating a huge lack of money, if you will, for the future. I can foresee the possibility that people on Social Security will wake up some day—those who are paying in now—and find they are being asked to pay twice, what they're paying in now and building up the reserves, the reserves are being borrowed and spent by the Government, and the people will be asked to make that whole.

Could you comment on that for a minute?

Mr. VOLCKER. I agree with you. I think the nature of this thing is that we are pretending, in a sense, that we're building up a surplus in those accounts. We are doing that in a bookkeeping sense. But for those surpluses to become effective in paying the bills into the next century, they should be converted into real savings and real investment and they are not being. Clearly, they are being dissipated by financing the Government in general and investment is very low.

If you're going to include—as we do and I think it's probably appropriate—Social Security programs in the general budget, for that surplus in Social Security accounts to have economic meaning we should be running a surplus in the overall budget and indeed we should be. Now we can't get there very quickly, but I think we ought to aim there. Otherwise, we are simply financing the general government expenditures with higher payroll taxes. We've had sizable increases in taxes. They happen to be largely payroll taxes paid into Social Security.

The CHAIRMAN. And we may be creating the rough equivalent of a future S&L problem where we will have taken in a different way spent and dissipated resources and then find later on that we've got to restore the resources that have been spent for other purposes to actually pay the Social Security claims.

So I can see us here in a different forum creating a problem over time where the money is being taken and it's being spent and it's all going to have to be replaced.

Mr. VOLCKER. Well, it implies either an enormous squeeze on Government expenditures or higher taxes out there in the middle of the next century—I guess it's after the first quarter of the next century when it begins turning around. That's so far away nobody looks at it I suppose, but that is the implication.

Under current Social Security payment schedules and obligations, the Social Security system will move into a huge deficit and that will move the whole budget into a big deficit unless taxes are raised or expenditures are reduced.

So I agree with you. Either the accounts can be taken out of the Government and invested in the private markets and then balance the rest of the Government accounts, or, if Social Security is kept in the overall budget, we should be running a surplus.

The CHAIRMAN. Thank you. I appreciate that. I know that was off the main subject of today, but it's very important I think that we touch on it.

I want to thank you again for your testimony. It's been very helpful to us and I know the members of the Committee feel that way. Thank you very much.

The committee stands in recess.

[Whereupon, at 12:35 p.m., the hearing was adjourned.]

[Response to written questions from Paul Volcker follows:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM PAUL VOLCKER — Hearing on February 7, 1989

Q. 1. In your testimony you commented that the failure of the Federal Reserve to pay interest on reserves is in effect an indirect tax. This indirect tax obviously puts banks and thrifts at a competitive disadvantage with money market funds that offer transaction accounts to customers. Do you believe that such funds should be required to maintain reserves at the Federal Reserve in order to level the playing field?

A. 1. In considering the appropriateness of reserve requirements for money market funds that offer transaction accounts, my recollection is that such transaction capabilities are in practice used relatively infrequently -- that is more in line with practices with respect to bank money market accounts than demand deposits or NOW accounts. The reserve requirement on bank money market accounts is small, limiting the competitive disadvantage. However, at current interest rates, the reserve requirement "tax" would still be equal to about 1/4 %, not a negligible competitive factor.

The easiest and most direct way to "level the playing field" would be to pay interest on commercial bank reserve requirements. If that course is rejected, then the competitive logic does suggest comparable requirements be placed on money market funds offering transaction capabilities. Such an approach would entail some administrative and definitional problems. More importantly, it would lead to still further debate about how to identify transaction accounts and other powers of money market mutual funds (including their access to the discount window).

My strong feeling is that the issue should preferably be approached by payment of interest on reserves.

Q. 2. You and others have spoken frequently of the "moral hazard" that occurs when a federally-insured depository institution's capital has been substantially depleted. The managers of such an institution have an incentive to make risky investments because they no longer have a substantial amount of capital that they would lose if the investments went sour. Isn't the same "moral hazard" present when an institutions's market value capital drops substantially, even if its GAAP capital does not? If so, should Congress require depository institutions to begin some form of market value reporting?

A. 2. I think analytically the "moral hazard" problem can arise if and when "market value" capital is depleted, whether that market value is measured directly by a low valuations of the equity in the market place or by computations of the market value of assests.

However, I would be reluctant to see a requirement for general market value accounting for banks. The basic economic function of banks is to transform pools of liquid assets into less liquid form, thereby making those funds more readily available to meet business and consumer needs. In that process of financial intermediation, some risks are inevitable and appropriate, and those risks may occur either because of fluctuations in interest rates or because of changes in the credit standing of borrowers. Some of the relevant changes in value are easy to measure (as when there is a good public market for the credit) while others are a matter of subjective judgement. In some cases, the risk is an interim interest rate risk (i.e. the maturity value is secure), while in other cases (and typically in the more subjective cases), the principal is at risk.

A requirement for full market value accounting would seem to me to unnecessarily chill the legitmate risk taking of banks, pushing those risks to the ultimate leaders or borrowers and impeding the efficiency of credit markets. Disclosure of valuation policies and market prices for traded securities and appropriate reserve and write-off policies, all enforced by supervision, should adequately meet the needs.

The remaining "moral hazard" problem should be dealt with by appropriate limits on insurance and adequate capital standards, recognizing that the latter are inevitably arbitrary at the margin and require informed judgement.

PROBLEMS OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION [FSLIC]

PART I OF IV

THURSDAY, FEBRUARY 9, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, the Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Cranston, Sarbanes, Dixon, Shelby, Graham, Wirth, Bryan, Garn, Heinz, D'Amato, Gramm, Bond, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

We will have this morning first the Attorney General of the United States and he will be followed by two other important witnesses who are here today to also testify on the issue of fraud and wrongdoing in the savings and loan problem situation.

I want to start out by saying we are very pleased to have the Attorney General and we wish you well with all your duties in the new administration. We are particularly interested in having you here this morning.

I will make just a few initial comments and then yield to my colleagues for the same purpose before we then call on the Attorney General.

All the information that we are receiving indicate that there is a very serious problem with fraudulent activity with respect to a large part of the savings and loan problem. Some of it has come to light in terms of actual case actions that have taken place, but the indications are that there are a very large number of cases that need to be taken up and need to be moved forward.

I want to say for my part, Mr. Attorney General, that I am very deeply troubled about this aspect of the problem and how it built up over the years. I feel very strongly that it's essential that we be very aggressive in finding each and every case in which there was wrongdoing, that we track down the people who were involved, and that we make a full effort to recover any financial assets that we can.

The latest estimates are that we've got at least a $100 billion problem to solve, and a large part of it appears to be money that was drained out of the system through improper activities. When that can be established and recovery of those funds can take place, I think we have an absolute need and requirement to do that.

I want to say that I appreciate very much the emphasis that the President put on that issue in terms of seeking a special appropriation of $50 million to augment your staff so that you will have the professional investigators and lawyers that you need to pursue these cases and to track down those cases of wrongdoing.

One of our witnesses later this morning will indicate that in his judgment as much as half of the total loss may be due to fraudulent activity. We'll have to hear that testimony and weigh it and make our own judgment about it, but those are very serious charges.

I would also say that there's concern as this problem has unfolded over the years, not just the self-dealing and out and out fraudulent activities that may have taken place, but even the question of the resolution of some of these things as to who had the opportunity to participate in very attractive arrangements and who did not. I would hope that the Department would look at every aspect of this situation.

If there was ever favoritism shown at any time in a way that would have disadvantaged this Government, I think that needs to be brought to light and set right. And, of course, any improper activities that can be found I think it's important that we go right to the last mile to deal with those situations.

The only other thought I want to express before yielding to Senator Garn is this. I think it's essential that the financial recovery take place that we go out and collect as much of this money that we possibly can. But I also think there's a very powerful object lesson that also has to be established. If people engage in activities that in effect defraud the Government, and the American people, they're going to be punished for it. Not only will we make every single effort within the Government to recover the money, but if there is the potential for people being sent to jail for improper activity, they will be prosecuted and sent to jail. That message will be there in the future for anybody else who thinks about crossing the line into fraudulent activity.

Before we start I have a statement from Senator Cranston to be inserted in the record.

OPENING STATEMENT OF SENATOR ALAN CRANSTON

Senator **Cranston**. Misconduct, fraud and other abuses have had disastrous consequences for the thrift industry, FSLIC, Government and the U.S. taxpayer. Examining the nature, extent and impact of fraud in federally insured financial institutions by officers, directors and outsiders along with the adequacy of efforts by the Federal bank regulatory agencies and the criminal justice system, will incease the possibility that fraud of this magnitude will not occur again.

The U.S. Government is now confronting a growing and long term epidemic of insider and outsider abuse cases. Evidence indicates that the criminal justice system has been overwhelmed with pending investigations. As of June 1988, there were 7,350 open FBI and Federal grand jury investigations, 46 percent of which involve violations with losses of $100,000 or more; one third of all these pending investigations were in California, Texas and Florida. Federal authorities expect these numbers to grow as the FSLIC moves to close down some 350 or more remaining insolvent thrifts.

The administration has committed $50 million to establish a special nationwide fraud unit as part of the thrift crisis plan.

While resources may be limited in most areas of the Nation to handle the problem, I am concerned how best we can utilize those limited resources adequately to make sure that wrong doers are punished and that this does not happen again.

Thank you, Mr. Chairman.

The **Chairman**. With that, let me yield to Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator **Garn**. Thank you, Mr. Chairman.

Mr. Attorney General, we are very pleased and honored that you would personally appear today. I think it shows evidence that the portion of the President's plan dealing with possible violations of the law and the recoveries that the chairman has talked about are of high importance. I think your presence here today indicates this, and the committee appreciates very much your taking the time to do this.

Today we do continue our hearings on the thrift crisis by examining the role of fraud and insider abuse. This is not a pretty sight, especially in States that let their S&L's go crazy with real estate speculation and other risky investments.

Just by way of comparison, back in 1980, Congress expanded the role of federally chartered S&L's to permit more direct real estate investments. But I emphasize only to a limit of 3 percent of their total assets. We heard a great deal about deregulation back in those days, but not many people are aware that that vast deregulation into real estate was all the way up to 3 percent at that time. And when Senator Riegle, as my ranking minority member back in 1982, helped pass the Garn-St Germain Act, we maintained that limit of 3 percent in direct investments.

But some States took a much different approach. Beginning in 1981, Texas allowed its State-chartered thrifts to invest up to 30 percent of their assets in direct real estate investments. California was even worse. In 1983, a California thrift could invest up to 100 percent of its assets in direct real estate investments or any other investment for that matter. That meant that a real estate speculator could buy a sleepy State-chartered savings and loan, attract huge deposits from all over the country using Federal deposit insurance, and invest all of the proceeds in anything—raw land, windmill farms, fast food franchises or anything else that they wanted to.

At the same time, capital requirements were low because of forbearance and, to be blunt about it, phony accounting, which meant that speculators in control of S&L's had very little of their own money at risk.

Add to that a regulatory system that OMB refused to expand and the result was an invitation to fraud, wild speculation, and insider abuse. We will hear in the testimony today that that is exactly what happened and we are now paying the price.

I believe there are several issues that must be addressed in this area and I hope our witnesses will discuss them today.

First, did the vast increase in State powers, particularly in the real estate area, create opportunities for fraud that did not exist with more traditional mortgage lending activities?

Second, what should Congress do about the potential for abuse that exists in expansive State-charters? How do we balance the risks with the benefits that everyone has acknowledged that the dual banking system has produced?

Third, are the abuses continuing or have the regulators who have beefed up their efforts in the last year gotten the situation under control?

Fourth, what has been done to punish the crooks that looted these institutions? Can more be done? Can we recover funds and put these people in jail? The American people are just now, I believe, waking up to the level of fraud in the system and the fact that they will have to pay for part of it. They are upset about it and so am I and so is this committee.

This leads me to my last question. What tools and funds do the regulators and the Justice Department need in addition to what they already have to aggressively pursue past abuses and deter future ones?

I think you will find, Mr. Attorney General, that Congress will be very sympathetic to requests for any additional help you need and requests that the regulators need.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

Senator WIRTH.

OPENING STATEMENT OF SENATOR WIRTH

Senator WIRTH. Thank you, Mr. Chairman. And thank you very much for being here. I'll just be very brief.

The concerns about fraud as you know have permeated recent discussions of the S&L crisis. The GAO did a study in detail of some 25 or 26 S&L's and found that of all of those frauds were deeply involved in the failure of those institutions. The estimate has been made that fraud or illegal insider information has permeated as much as 60 to 75 percent of the S&L's that are in trouble. We've got a major problem on our hands, as you well know, and I appreciate your being here.

I was struck by an article late last week that suggested that there was an attempt by the Justice Department—

> The Justice Department says it wants to put several of the top officials of the failed San Marino Savings and Loan in California in jail for their part in the fraudulent conduct that helped doom the thrift at a cost to taxpayers of more than $200 million. But, says U.S. Attorney Robert Bonner of Los Angeles, we can't even try. Without consulting the Justice Department, Federal S&L regulators promised some San Marino officials that they wouldn't face criminal prosecution if they helped regulators recover part of the money that had been lost when the S&L collapsed in 1984.

We have a pattern of Federal regulators reaching very far in the S&L industry making commitments on behalf of the taxpayers.

Now the allegation is that they are making enormous commitments on behalf of our judicial system as well.

I think we have really got to understand all of this. I know that you're prepared to address that and, as Senator Garn said, we are here to give you whatever resources and help that you need to do the job.

Thank you very much for being with us.

The Chairman. Thank you.

Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'Amato. Thank you very much, Mr. Chairman, and let me commend you for calling this hearing and the Attorney General as well for making himself available on such short notice.

Mr. Chairman, I'm going to ask that the full text of my remarks be included in the record as if read in their entirety and I'd like to point out that according to a report of the House Committee on Government Operations dated October 1988, fraud was a primary or contributing factor in 75 percent of the failed thrifts.

I suggested to this committee 2 days ago that I've heard from my constituents and there was real outrage and I've had people say, "What are we going to do to correct this? Why should we be paying the freight?" That's why I think it's so important to have this hearing because I think the American people must be assured that at least we in government are going to do everything possible to recover as much as we possibly can and to bring those to justice, and the full measure of justice, for those who have looted these thrifts, have looted the American people, in essence.

Some of the cases—and they are legion—but just some of the examples are horrendous where we have a former vice chairman of the Dallas Federal Home Loan Bank Board and another principal shareholder of Empire Savings, and they have been charged with misappropriation in over $100 million from Empire Thrift which became insolvent.

And the granddaddy of them all so far was the Vernon Savings. Between its acquisition in 1982 by one of these real estate developers, as Senator Garn indicated, it's a sleepy little bank, a condominium developer comes in and the day that it was closed 5 years later Vernon bought five airplanes, a yacht, $5 million worth of art works, a $2 million beach house in California, tens of thousands of dollars that they spent on flowers, $800,000 in living expenses for the thrift owner and his wife while they used the California beach house. When it was closed in 1987, Vernon was not collecting on 96 percent of its loans and its losses exceed over $600 million.

It's been reported by the Chicago Tribune that for 4 years earlier the Federal and State examiners began to question some of the practices of Vernon. I think it's rather important too, in addition to criminal prosecution, we find out what happened for 4 years, how was it the regulators allowed this to take place? Were they involved themselves? Of course, most important is to assure the Attorney General that whatever resources he needs—and obviously additional resources in terms of personnel, prosecutors, investigators, accountants, et cetera will be necessary—that this committee stands ready to assist him in seeing to it that he has the necessary resources.

So, Mr. Chairman, let me commend you for this hearing and the Attorney General for his promptness in responding.

[Complete prepared statement of Senator D'Amato follows:]

PREPARED STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, today we address the most serious matter in this series of hearings. Only if we successfully address this issue can we face the taxpayers and ask them to contribute to the funding solution to the FSLIC crisis. The American people must be assured that the Government is doing all it can to exact the full measure of retribution against the guilty who have looted thrift institutions and the FSLIC.

According to the report of the House Government Operations Committee, the Bank Board estimates that fraud was the primary or a contributing factor in 75 percent of thrift failures. Owners, managers, officers and borrowers of thrift institutions were amoung the culprits. Real estate appraisers, outside auditors, bank examiners and even regional Bank Board members have often been either reckless or grossly incompetent. None of these general allegations are new and some people who are very familiar with this situation may be numb from repetition. The specifics of only a few cases are nonetheless astounding.

A former vice chairman of the Dallas Federal Home Loan Bank, and another principal shareholder of Empire Savings and Loan have been charged with misappropriating over $100 million from Empire, a thrift which became insolvent.

Sunbelt Savings, another insolvent thrift which lost $1.2 billion in a single quarter of 1988, spent $1.3 million on Christmas and Halloween parties in 1984 and 1985. At the center of this grotesque spectacle, the man who ran this institution into the ground presided over one of these lavish parties dressed as a King. He may have seen himself as Santa Claus, handing out federally insured gifts, but the whole thing was more like the Texas chainsaw gang turned loose on the very structure of the thrift industry.

The granddaddy of them all—so far—was Vernon Savings. Between its acquisition in 1982 by a Dallas condominium developer and the day the FSLIC closed it in 1987, Vernon bought five airplanes, a yacht, $5 million worth of art works, a $2 million beach house in California and at least $36,780 worth of flowers. The flowers were part of the $800,000 in living epxenses for the thrift's owner and his wife while they used the California beach house.

When it was closed in 1987, Vernon was not collecting on 96 percent of its loans and its losses exceeded $600 million. It is reported in the Chicago Tribune that, 4 years earlier, Federal and State examiners began to question some of the practices of Vernon. What happened for 4 years?

Not all the news is bad on the enforcement front. FSLIC is having some success at obtaining restitution orders in civil actions. John Mmahat (Mamahat) was recently ordered to repay $35 million which he had stolen from a thrift. Such judgments give the FSLIC claims against "officer and director" insurance carriers and others who may be liable through a thrift's fraudulent managers. Therefore, effective action may get some of the taxpayers' money back.

Furthermore, the Bank Board's examiners are at least more sensitive to the need to coordinate their efforts with the Justice Department and to make referrals of cases of suspected criminal activity.

As I am sure our witnesses will point out, criminal actions take time. Recently, after 5 years of work the U.S. Attorney in Chicago got convictions and sentences of 3, 6 and 7½ years against three managers of First Financial Savings and Loan. Additionally, these three convicts were ordered to make restitution of $16 million to the FSLIC.

Such results offer a thin ray of hope on this bleak FSLIC landscape. They also argue for patience nd recognition that bringing the guilty to justice is a tedious, resource-intensive job, especially in complex cases. Indeed some thrift operators have claimed to be insulated from conviction simply because the transactions involved are too complex for a jury to understand. I, for one, have more faith than that in juries; but there is a kernel of truth in the statement. Many prosecutors and investigators are needed if we are to put the looters in jail—and this we must do. So we must bear in mind that this is a long haul as we focus on the fraud problem.

Finally, I would like to assure the Department of Justice of my personal interest and support in this important effort.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator D'Amato.

Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator **Heinz**. Thank you, Mr. Chairman.

It's kind of a special pleasure for me to welcome two Pennsylvanians, Dick Thornburgh from Pittsburgh and Ed Dennis from Philadelphia. They are law enforcement professionals with great experience of the highest order. I don't know when our Nation has been as well served by having two people who have actually been in the trenches fighting and winning the war against crime and who, in their various responsibilities in the past, have been so successful.

They are truly a dynamic duo. Perhaps it's coincidence, but I think not, that in my home State of Pennsylvania where Dick Thornburgh served for 8 years as Governor and did a superb job keeping our State clean, as well as balancing its budget, and where Ed Dennis served as U.S. Attorney for the better part of 8 years, there have not been the kinds of fraud and stealing in the savings and loan or financial institutions that, unfortunately, occurred elsewhere. Maybe it was because we had those two guys on the block making sure that nobody got the wrong idea. Whatever the reason, I'm delighted they are here.

I also want to say that having talked to Dick Thornburgh yesterday, I know he is utterly committed to helping us clean out the nest of thieves that have looted our savings and loans.

I must say, as I look at it, it seems to me that while the depositors were walking away with toasters, some of the savings and loans executives were walking away with all the bread. By the time the FSLIC took over those insolvent thrifts, the American taxpayer was left holding the bag.

Fraud, insider abuse, outright theft in our Nation's financial institutions can simply no longer be ignored. I know Dick Thornburgh and President George Bush know that. While we have the cameras, the guards, and the alarms to stop robbers at the front door, we have let white collar criminals carry billions of dollars out the back door. It's time to lock criminals outside of the board rooms and into the jail rooms.

Mr. Chairman, it may be that members of this committee differ on some elements of the President's program, but I don't think this is one of them. The President has proposed $50 million in enhanced enforcement efforts for the Justice Department and I believe there is unanimous support for that augmentation of Dick Thornburgh's resources.

I would only conclude by saying I intend to urge the rest of our colleagues in the Congress to give the Attorney General the resources to implement what I call a new type of deposit insurance system. Under this plan, crooks and crooked bank and thrift officers are going to be deposited promptly in prison and stiff fines and long jail terms would be totally ensured. I think Ed Dennis and Dick Thornburgh are the two people to do that and I want to hear their testimony so I'll stop.

The **Chairman**. Thank you, Senator Heinz.

Before calling on Senator Bond, I just want to acknowledge his particular leadership on this fraud issue. You have been in the forefront of drawing focused attention to this issue and I know you drafted legislation which very substantially tightens and strengthens the laws in this area and I appreciate that leadership effort on your part and I yield to you at this time.

OPENING STATEMENT OF SENATOR BOND

Senator BOND. Well, Mr. Chairman, I thank you very much and I obviously am very pleased and delighted with the leadership that you have shown in this entire area. I thank you very much for holding this hearing today. I want to commend my former colleague, Dick Thornburgh, for taking time from a very challenging period in any new administration to come here and talk to us today about the very, very significant subject that we have before us.

And I think it is a good sign of the good working relationship, the bipartisan cooperation, that we're seeing in Washington today to deal with a critically important problem.

We have to examine I think very carefully the role that fraud has played in running up the $100 billion bill for FSLIC's insolvency. Some say it may go higher, it may be less, but that's a nice round number that even should get our attention where we are used to dealing with billions of dollars.

All of us I think, Mr. Chairman, are very disturbed about the percentage of FSLIC losses that may have been caused by criminal behavior. Certainly many of the problems that we see in the savings and loan industry were caused by an economic decline in the Southwest and interest rate mismatches put the industry at risk, but there have been flamboyant and outrageous cases of fraud and probably criminal activity involved. It reflects very poorly on our entire financial system when a few unscrupulous individuals are able to use federally insured deposits as private slush funds.

Federal deposit insurance was meant to stabilize the financial system and reassure savers. It should not be used to fund trips to Europe, fancy cars or, as my colleague from New York has pointed out, expensive beach houses. Those who have looted banks or savings and loans to fund their lavish lifestyles deserve to be dealt with very severely.

These instances that we are considering here today give new meaning to the old saw that the easiest and best way to rob a bank or savings and loan is to own one. We are all familiar with some of the spectacular anecdotes about the operators of certain failed S&L's. The evidence about the role that fraud has played in both thrift and bank failures is more than just a few anecdotes. Studies by the GAO, OCC, and the House Government Operations Committee, which have been cited already today, all suggest that fraud is a significant factor in losses suffered by the deposit insurance funds.

This evidence convinced me to introduce a bill in the 100th Congress and, as the chairman has graciously noted, again this week, to stiffen the penalties for defrauding a financial institution. It's vital that any S&L legislation that this committee reports out includes stiffer criminal penalties in addition to broader civil enforcement powers for the regulators.

I am very pleased that President Bush has included such strong fraud and enforcement provisions in his proposal and I especially commend him for the idea of using $50 million of the funding to pay for additional prosecutors and enforcement mechanisms at the Justice Department.

All of this brings us to the broader question of how seriously we in this society take white collar crime. The insider trading cases, commodities fraud investigations, and defense procurement scandals, in addition to the S&L mess, all suggest that there may be a real weakness in our system in that many well-paid professionals seem to think they can get away with stealing. A slap on the wrist or even a short jail term are not enough punishment for those whose illegal wheeling and dealing will cost the taxpayers billions.

I look forward to the testimony of the witnesses and thank you again, Mr. Chairman, for calling this hearing and devoting the attention of the committee to this subject.

The CHAIRMAN. Thank you, Senator Bond.

Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Mr. Chairman, let me thank you for this hearing and for all the others you've conducted. I think your leadership in moving us toward the resolution of the crisis facing the nation is something that's going to be long remembered, not just here but around the country.

Mr. Attorney General, I welcome you before the committee. I think it's clear from everything that's been said earlier that we are of one mind in our desire to grab by the throat those who have profiteered and violated the law at the expense of the deposit insurance corporation and have contributed, in a significant way, to bringing us to this unhappy day where we look at putting the taxpayer at risk for $50 billion of losses in the savings and loan industry.

I personally believe that with vigorous prosecution we can recover a substantial amount of money from people who, in essence, stole that money from the taxpayer. I think it's vitally important that we do that. I think in some cases the amounts recovered are not going to be significant. I'm aware of the old adage, that I've repeated before in this committee, the old adage that you can't get blood out of a turnip. But I think we can get a lot of satisfaction from roughing up a turnip. I think it's vitally important that we move against those who have defrauded the system, that we do everything possible to recover the taxpayers' money, that we vigorously prosecute those who are guilty of crimes, and that we make an all-out effort to assure that no wrongdoer ends up profiting after we go through this very difficult process of setting the system right.

So I can assure you, this committee supports vigorous prosecution. We want you to find your meanest and toughest prosecutors, and we want you to go after these people. We are going to be supportive of that effort. If funds are required to do it, we are willing to make that part of this bill.

I thank you, Mr. Chairman.

Senator HEINZ. The two of the meanest are sitting right there.

The CHAIRMAN. I have the feeling that if we needed an exemption from Gramm-Rudman-Hollings for the money for additional prosecutors that we might be able to appeal to the gentleman from Texas.

Senator GRAMM. And I might say that my dear colleague on my right here passed me this new scripture—vengeance is mine sayeth the Banking Committee. [Laughter.]

The CHAIRMAN. Senator Graham of Florida.

OPENING STATEMENT OF SENATOR GRAHAM

Senator GRAHAM. Thank you, Mr. Chairman.

I look forward to the remarks of my good friend, the Attorney General, and am pleased that he is taking such an aggressive lead on this important dimension of the overall travails of the thrift industry.

While you are looking at some of the past misdeeds, I hope that you will also be mindful of the fact that there is another set of institutions which have been gradually sliding toward what could eventually be insolvency and if there are any steps that you believe we should take in order to carve out any misdeeds from those institutions so as to save them from the fate that has already befallen 500-plus of their brethren, I would be particularly appreciative and I think this committee would take appropriate attention and action.

I look forward eagerly to hear your statement.

The CHAIRMAN. I should make one other comment, Mr. Attorney General, before asking you for your statement.

That is, while we are here today to focus on the fraud problem and we've all commented on it very directly, this industry, like many industries, is dominated by people of integrity, who work hard every day, who are honest, who obey the rules, and the overwhelming number of savings and loans across the country are in good hands and have not caused this problem. It is unfortunate that those that have conducted themselves improperly have created a problem which radiates out and in a sense casts a cloud over the entire industry. But I think in fairness we should note that the fact that there have been some very bad people in this business, there are an awful lot of good ones out there and they ought not to have their reputations stained by the deeds of others.

Senator Pressler has joined us. Senator Pressler, would you have an opening comment to make?

Senator PRESSLER. I do have an opening comment. I will submit it for the record in the interest of time.

I join in welcoming the Attorney General and the other gentlemen who are appearing here today. I wish to place my statement in the record.

The CHAIRMAN. Without objection, it will be done.

[Committee insert of Senator Pressler's opening statement follows:]

OPENING STATEMENT OF SENATOR LARRY PRESSLER

Senator **Pressler**. Mr. Chairman. Thank you. I wish to commend you, Mr. Chairman, for calling today's hearing. The matter of illegal and fraudulent activity that exists in numerous savings and loan businesses is one of the most troublesome aspects in the crisis confronting us.

It is imperative that we attack fraud and illegal dealing to the maximum extent possible—not only at the Federal level but also at the State level. Since it is a huge job involving billions of dollars, we should use every available resource. The culprits should be prosecuted under our criminal laws. Maximum fines should be imposed, and civil recoveries should be made wherever possible.

Statutes of limitation are running, so our law enforcement people cannot delay in moving ahead. That is one of the reasons I suggest our State governments should be more involved in these activities.

I applaud the President for the emphasis his reform program places upon upgrading enforcement and increasing penalties for fraud against financial institutions and depositors. I join in welcoming Attorney General Thornburgh and the other gentlemen who are appearing here today to testify on this vital subject. I look forward to hearing their testimony.

Thank you, Mr. Chairman.

The **Chairman**. Mr. Attorney General, we're very pleased to hear from you now.

STATEMENT OF RICHARD L. THORNBURGH, ATTORNEY GENERAL OF THE UNITED STATES, DEPARTMENT OF JUSTICE, ACCOMPANIED BY EDWARD S.G. DENNIS, JR., ASSISTANT ATTORNEY GENERAL, CRIMINAL DIVISION

Attorney General **Thornburgh**. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I am pleased to be here with Assistant Attorney General Edward Dennis, the head of the Criminal Division of the Department of Justice, to address the President's proposal to deal with the serious problem of fraud and insider abuse affecting some of our Nation's financial institutions. I will discuss with you this morning what we at the Department of Justice are doing about this problem, and what we plan to do under the savings and loan reform initiative announced by President Bush earlier this week.

FRAUD AND INSIDER ABUSE

Fraud and insider abuse are believed conservatively to have been involved in 25 to 30 percent of the savings and loan failures. Over the last decade there has been a steady increase in the number of insolvent federally insured banks and savings and loan associations with estimated losses in cases involving fraud and embezzlement amounting to over $2 billion in 1988 alone.

Members this morning have outlined some of the more egregious instances of this type of wrongdoing and I won't belabor it further.

My experience as a Federal prosecutor teaches that the best way to deter fraud is with tough, timely, and effective law enforcement. There are really two important roles that law enforcement efforts can play. One obviously is the prosecution of those who have violated the law in connection with these failures; the other is to provide some suggestions for remediation as we develop these cases and uncover patterns that can be better dealt with by the regulatory structure.

Attacking savings and loan fraud and insider abuses is a key part of our crackdown on white collar crime, what some call "crime in the suites", joining our recently announced initiatives targeting securities and commodities fraud and ongoing investigations of alleged wrongdoing in the defense procurement area.

Shortly after I assumed office, I conducted a review of Department of Justice activities in the area of savings and loan fraud. I learned that in recent years we have made significant advances in coordinating our attack on crime in financial institutions but that we lacked significant resources to address the problem fully.

INTERAGENCY BANK FRAUD ENFORCEMENT WORKING GROUP

In 1984, concerned with financial institutions that were becoming increasingly vulnerable to insider fraud and that prosecutions were not keeping pace with criminality, then Attorney General William French Smith and officials of the Federal Home Loan Bank Board, the Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation officials formed the Interagency Bank Fraud Enforcement Working Group. This working group was charged with designing improvements in the detection, investigation, and prosecution of fraud against financial institutions.

The working group has in fact improved both communication and coordination among its members, resulting in a tighter bond between the agencies and the law enforcement community.

It has produced a uniform criminal referral form for use by all federally insured financial institutions and supervisory agencies to facilitate prompt reporting of suspected crimes. Moreover, it has promoted a program called "Fast Track", which is designed to facilitate the economical, effective prosecution of certain financial institution frauds which would otherwise escape criminal prosecution.

BANK FRAUD INVESTIGATION TRAINING PROGRAM

We have also instituted a comprehensive bank fraud investigation training program, including several joint training courses for FBI agents and bank examiners. In addition, two bank fraud seminars for prosecutors and agency attorneys have been presented through the Attorney General's Advocacy Institute.

A significant case tracking system was established to identify criminal referrals identified by concerned supervisory bank agencies. Finally, the working group successfully sought amendments to the Right to Financial Privacy Act, which you passed last fall and which are designed to facilitate the timely sharing of information among financial institutions, their regulators, and law enforcement authorities.

A prime example of what cooperation and commitment to bringing prosecutions against those who prey in financial institutions can do is seen in our task force in the northern district of Texas. This year-old effort, involving the U.S. attorney's office, the FBI, the Criminal and Tax Divisions of the Justice Department, the Internal Revenue Service, and the Federal Home Loan Bank Board, was launched to identify and prosecute crimes directed against savings and loan associations and banks in that district.

DALLAS BANK FRAUD TASK FORCE

Currently, 12 attorneys from the Criminal Division's fraud section, 4 Assistant U.S. Attorneys, 25 FBI agents, and 16 IRS investigators constitute what has become known as the Dallas bank fraud task force, a model investigative and prosecutive operation which has trained its sights on extensive allegations of wrongdoing in the Dallas area savings and loan community.

The task force thus far has brought criminal charges against 33 individuals, 8 indictments and 16 informants. There have been 20 convictions, 15 guilty pleas, and 5 jury verdicts, and only 1 acquittal. Three defendants are on trial and 6 are awaiting trial. Twelve defendants have been sentenced, 8 receiving imprisonment while 4 were placed on probation. Generally, the imprisonment ranged from 6 months to 1 year, but in one case the defendant received a 35-year jail term. Fines totaling $133,250 have been imposed and restitution totaling $2,791,500 has been ordered.

Financial institution fraud prosecutions have occurred and are occurring in a number of other districts, particularly in the sunbelt region—California, Oklahoma, and Florida—but also in New York, Colorado, Kansas, and Minnesota. I have made it clear to the U.S. attorneys that this is a high priority enforcement area. But I must tell you that existing investigative and prosecutive resources have not been sufficient to address all the serious criminality called to the attention of the Department of Justice.

The President's comprehensive plan dealing with the savings and loan problem would increase the budget of the Justice Department by approximately $50 million. This increase could be used to provide on the order of 200 new investigators, over 100 new prosecutors, 30 or more other new attorneys, plus additional support personnel to strengthen the enforcement of criminal and civil laws concerning financial institution fraud.

It will almost double the personnel devoted to the apprehension and prosecution of individuals committing fraud in our financial institutions, supporting in excess of 600 new positions dedicated to addressing fraud and insider abuse in savings and loans and other financial institutions where these problems exist.

In addition, we will develop new specialized training programs for prosecutors in S&L and financial institution fraud enforcement. Some resources would be devoted to strengthening the administrative capabilities pertaining to coordination of interagency task force activities devoted to financial institution fraud, and to the enhancement of financial institution fraud case tracking capabilities.

The increase in attorney and support staff in the litigating divisions would enhance our ability to carry out two substantial missions: To provide a nucleus of experienced prosecutors for task forces similar to that established in the Dallas area; and to augment the resources of those U.S. attorneys' offices that may not require a substantial increase in their own resources to cope with a regional crisis in bank fraud enforcement, but that may from time to time need assistance in investigating and prosecuting such cases when their own resources are insufficient for those cases.

These critical, additional resources will help keep the President's solemn pledge made to the American people earlier this week when he said:

> We will make every effort to recover assets diverted from these institutions, and to place behind bars those who have caused losses through criminal behavior. Let those who would take advantage of the public trust and put at risk the savings of American families anticipate that we will seek them out, pursue them relentlessly and demand the most severe penalties.

We at the Department of Justice are committed to fulfilling the President's pledge if the resources are made available.

Mr. Chairman, I appreciate the opportunity to be with you here today. Mr. Dennis and I are available to answer your questions. Thank you.

[The complete prepared statement of Attorney General Richard L. Thornburgh follows:]

Department of Justice

STATEMENT

OF

DICK THORNBURGH
ATTORNEY GENERAL

BEFORE

THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

CONCERNING

FRAUD IN THE SAVINGS AND LOAN ASSOCIATION AREA

ON

FEBRUARY 9, 1989

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE,

I AM PLEASED TO BE HERE TO ADDRESS THE PRESIDENT'S PROPOSAL TO DEAL WITH THE SERIOUS PROBLEM OF FRAUD AND INSIDER ABUSE AFFECTING SOME OF OUR NATION'S FINANCIAL INSTITUTIONS. I WILL DISCUSS WITH YOU WHAT WE AT THE DEPARTMENT OF JUSTICE ARE DOING ABOUT THIS PROBLEM, AND WHAT WE PLAN TO DO UNDER THE SAVINGS AND LOAN REFORM INITIATIVE ANNOUNCED BY PRESIDENT BUSH EARLIER THIS WEEK.

FRAUD AND INSIDER ABUSE ARE BELIEVED TO HAVE BEEN INVOLVED IN TWENTY-FIVE TO THIRTY PERCENT OF SAVINGS AND LOAN FAILURES. OVER THE LAST DECADE THERE HAS BEEN A STEADY INCREASE IN THE NUMBER OF INSOLVENT FEDERALLY INSURED BANKS AND SAVINGS AND LOAN ASSOCIATIONS WITH ESTIMATED LOSSES IN CASES INVOLVING FRAUD AND EMBEZZLEMENT AMOUNTING TO OVER $2 BILLION IN 1988, ALONE.

MY EXPERIENCE AS A UNITED STATES ATTORNEY AND ASSISTANT ATTORNEY GENERAL, AND AS ATTORNEY GENERAL TEACHES THAT THE BEST WAY TO DETER FRAUD IS WITH TOUGH, TIMELY, AND EFFECTIVE LAW ENFORCEMENT. THERE ARE REALLY TWO IMPORTANT ROLES THAT LAW ENFORCEMENT EFFORTS CAN PLAY. ONE OBVIOUSLY IS THE PROSECUTION OF THOSE WHO HAVE VIOLATED THE LAW IN CONNECTION WITH FAILURES;

THE OTHER IS TO PROVIDE SOME SUGGESTIONS FOR REMEDIATION AS WE DEVELOP THESE CASES AND UNCOVER PATTERNS THAT CAN BE BETTER DEALT WITH BY THE REGULATORY STRUCTURE.

ATTACKING S&L FRAUD AND INSIDER ABUSES IS A KEY PART OF OUR CRACKDOWN ON WHITE COLLAR CRIME, WHAT SOME CALL "CRIME IN THE SUITES," JOINING OUR RECENTLY ANNOUNCED INITIATIVES TARGETING SECURITIES AND COMMODITIES FRAUD AND ONGOING INVESTIGATIONS OF ALLEGED WRONGDOING IN THE DEFENSE PROCUREMENT AREA.

SHORTLY AFTER I ASSUMED OFFICE, I CONDUCTED A REVIEW OF DEPARTMENT OF JUSTICE ACTIVITIES IN THE AREA OF SAVINGS AND LOAN FRAUD. I LEARNED THAT IN RECENT YEARS WE HAVE MADE SIGNIFICANT ADVANCES IN COORDINATING OUR ATTACK ON CRIME IN FINANCIAL INSTITUTIONS BUT THAT WE LACKED SIGNIFICANT RESOURCES TO ADDRESS THE PROBLEM FULLY.

INTERAGENCY BANK FRAUD ENFORCEMENT WORKING GROUP

IN 1984, CONCERNED THAT FINANCIAL INSTITUTIONS WERE BECOMING INCREASINGLY VULNERABLE TO INSIDER FRAUD AND THAT PROSECUTIONS WERE NOT KEEPING PACE WITH CRIMINALITY, THEN ATTORNEY GENERAL WILLIAM FRENCH SMITH AND OFFICIALS OF THE FEDERAL HOME LOAN BANK BOARD (FHLBB), THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (FRB), OFFICE OF THE COMPTROLLER OF THE CURRENCY (OCC),

AND FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC) FORMED THE INTERAGENCY BANK FRAUD ENFORCEMENT WORKING GROUP (BFWG). BFWG WAS CHARGED WITH DESIGNING IMPROVEMENTS IN THE DETECTION, INVESTIGATION, AND PROSECUTION OF FRAUD AGAINST FINANCIAL INSTITUTIONS.

THE BFWG HAS IN FACT IMPROVED BOTH COMMUNICATION AND COORDINATION AMONG ITS MEMBERS, RESULTING IN A TIGHTER BOND BETWEEN THE AGENCIES AND THE LAW ENFORCEMENT COMMUNITY.

IT HAS PRODUCED A UNIFORM CRIMINAL REFERRAL FORM FOR USE BY ALL FEDERALLY INSURED FINANCIAL INSTITUTIONS AND SUPERVISORY AGENCIES TO FACILITATE PROMPT REPORTING OF SUSPECTED CRIMES. MOREOVER, IT HAS PROMOTED A PROGRAM CALLED "FAST TRACK," WHICH IS DESIGNED TO FACILITATE THE ECONOMICAL, EFFECTIVE PROSECUTION OF CERTAIN FINANCIAL INSTITUTION FRAUDS WHICH WOULD OTHERWISE ESCAPE CRIMINAL PROSECUTION.

WE HAVE ALSO INSTITUTED A COMPREHENSIVE BANK FRAUD INVESTIGATION TRAINING PROGRAM, INCLUDING SEVERAL JOINT TRAINING COURSES FOR FBI AGENTS AND BANK EXAMINERS. IN ADDITION, TWO BANK FRAUD SEMINARS FOR PROSECUTORS AND AGENCY ATTORNEYS HAVE BEEN PRESENTED THROUGH THE ATTORNEY GENERAL'S ADVOCACY INSTITUTE.

A SIGNIFICANT CASE TRACKING SYSTEM WAS ESTABLISHED TO IDENTIFY CRIMINAL REFERRALS IDENTIFIED BY CONCERNED SUPERVISORY

BANK AGENCIES. FINALLY, THE BFWG SUCCESSFULLY SOUGHT AMENDMENTS TO THE RIGHT TO FINANCIAL PRIVACY ACT DESIGNED TO FACILITATE THE TIMELY SHARING OF INFORMATION AMONG FINANCIAL INSTITUTIONS, THEIR REGULATORS, AND LAW ENFORCEMENT AUTHORITIES.

ENFORCEMENT EFFORTS

A PRIME EXAMPLE OF WHAT COOPERATION AND COMMITMENT TO BRINGING PROSECUTIONS AGAINST THOSE WHO PREY ON FINANCIAL INSTITUTIONS CAN DO IS SEEN IN OUR TASK FORCE IN THE NORTHERN DISTRICT OF TEXAS. THIS YEAR OLD EFFORT, INVOLVING THE UNITED STATES ATTORNEY'S OFFICE, THE FBI, THE CRIMINAL AND TAX DIVISIONS, THE INTERNAL REVENUE SERVICE (IRS), AND THE FHLBB, WAS LAUNCHED TO IDENTIFY AND PROSECUTE CRIMES DIRECTED AGAINST SAVINGS AND LOAN ASSOCIATIONS AND BANKS IN THE DISTRICT.

CURRENTLY MORE THAN TWELVE ATTORNEYS FROM THE CRIMINAL DIVISION 'S FRAUD SECTION, FOUR ASSISTANT U.S. ATTORNEYS, TWENTY-FIVE FBI AGENTS AND SIXTEEN IRS INVESTIGATORS CONSTITUTE WHAT HAS BECOME KNOWN AS THE DALLAS BANK FRAUD TASK FORCE, A MODEL INVESTIGATIVE AND PROSECUTIVE OPERATION WHICH HAS TRAINED ITS SIGHTS ON EXTENSIVE ALLEGATIONS OF WRONGDOING IN THE DALLAS AREA SAVINGS AND LOAN COMMUNITY.

THE TASK FORCE HAS BROUGHT CRIMINAL CHARGES (8 INDICTMENTS AND 16 INFORMATIONS) AGAINST 33 INDIVIDUALS TO DATE. THERE HAVE BEEN 20 CONVICTIONS (15 GUILTY PLEAS AND FIVE JURY VERDICTS OF GUILTY) AND ONLY ONE ACQUITTAL. THREE DEFENDANTS ARE ON TRIAL AND SIX ARE AWAITING TRIAL. TWELVE DEFENDANTS HAVE BEEN SENTENCED. EIGHT RECEIVED IMPRISONMENT AND FOUR WERE PLACED ON PROBATION. GENERALLY, IMPRISONMENT RANGED FROM SIX MONTHS TO ONE YEAR, BUT ONE DEFENDANT RECEIVED 35 YEARS' IMPRISONMENT. FINES TOTALING $133,250 HAVE BEEN IMPOSED AND RESTITUTION TOTALING $2,791,500 HAS BEEN ORDERED ($591,500 OF THE RESTITUTION WAS DIRECTED TO THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION).

FINANCIAL INSTITUTION FRAUD PROSECUTIONS HAVE OCCURRED AND ARE OCCURRING IN A NUMBER OF OTHER DISTRICTS, PARTICULARLY IN THE SUNBELT REGION -- CALIFORNIA, OKLAHOMA, COLORADO, AND FLORIDA -- BUT ALSO IN NEW YORK, KANSAS, AND MINNESOTA. I HAVE MADE IT CLEAR TO THE UNITED STATES ATTORNEYS THAT THIS IS A HIGH PRIORITY ENFORCEMENT AREA. BUT EXISTING INVESTIGATIVE AND PROSECUTIVE RESOURCES HAVE NOT BEEN SUFFICIENT TO ADDRESS ALL THE SERIOUS CRIMINALITY CALLED TO THE ATTENTION OF THE DEPARTMENT OF JUSTICE.

THE ADMINISTRATION'S PROPOSAL

THE PRESIDENT'S COMPREHENSIVE PLAN DEALING WITH THE SAVINGS AND LOAN PROBLEM WOULD INCREASE THE BUDGET OF THE JUSTICE

DEPARTMENT BY APPROXIMATELY $50 MILLION. THE INCREASE WOULD BE USED TO PROVIDE IN THE ORDER OF 200 NEW INVESTIGATORS, OVER A HUNDRED NEW PROSECUTORS, THIRTY OR MORE OTHER NEW ATTORNEYS, PLUS ADDITIONAL SUPPORT PERSONNEL TO STRENGTHEN THE ENFORCEMENT OF CRIMINAL AND CIVIL LAWS CONCERNING FINANCIAL INSTITUTIONS FRAUD.

IT WILL ALMOST DOUBLE THE PERSONNEL DEVOTED TO THE APPREHENSION AND PROSECUTION OF INDIVIDUALS COMMITTING FRAUD IN OUR FINANCIAL INSTITUTIONS. IT WILL SUPPORT IN EXCESS OF 600 NEW POSITIONS DEDICATED TO ADDRESSING FRAUD AND INSIDER ABUSE IN S&LS AND OTHER FINANCIAL INSTITUTIONS WHERE THESE PROBLEMS EXIST.

IN ADDITION, WE WILL DEVELOP NEW SPECIALIZED TRAINING PROGRAMS FOR PROSECUTORS IN S&L AND FINANCIAL INSTITUTION FRAUD ENFORCEMENT. SOME RESOURCES WOULD BE DEVOTED TO STRENGTHENING THE ADMINISTRATIVE CAPABILITIES PERTAINING TO COORDINATION OF INTERAGENCY TASK FORCE ACTIVITIES DEVOTED TO FINANCIAL INSTITUTION FRAUD, AND TO ENHANCEMENT OF FINANCIAL INSTITUTION FRAUD CASE TRACKING CAPABILITIES.

THE INCREASE IN ATTORNEY AND SUPPORT STAFF IN THE LITIGATING DIVISIONS WOULD ENHANCE OUR ABILITY TO CARRY OUT TWO SUBSTANTIAL MISSIONS: TO PROVIDE A NUCLEUS OF EXPERIENCED PROSECUTORS FOR TASK FORCES SIMILAR TO THAT ESTABLISHED IN THE DALLAS AREA; AND

TO AUGMENT THE RESOURCES OF THOSE UNITED STATES ATTORNEYS' OFFICES THAT MAY NOT REQUIRE A SUBSTANTIAL INCREASE IN THEIR OWN RESOURCES TO COPE WITH A REGIONAL CRISIS IN BANK FRAUD ENFORCEMENT, BUT THAT MAY FROM TIME TO TIME NEED ASSISTANCE IN INVESTIGATING AND PROSECUTING SUCH CASES WHEN THEIR OWN RESOURCES ARE INSUFFICIENT FOR THOSE CASES.

THESE CRITICAL ADDITIONAL RESOURCES WILL HELP KEEP THE PRESIDENT'S SOLEMN PLEDGE TO THE AMERICAN PEOPLE WHEN HE SAID:

> "...THAT WE WILL MAKE EVERY EFFORT TO RECOVER ASSETS DIVERTED FROM THESE INSTITUTIONS, AND TO PLACE BEHIND BARS THOSE WHO HAVE CAUSED LOSSES THROUGH CRIMINAL BEHAVIOR. LET THOSE WHO WOULD TAKE ADVANTAGE OF THE PUBLIC TRUST AND PUT AT RISK THE SAVINGS OF AMERICAN FAMILIES ANTICIPATE THAT WE WILL SEEK THEM OUT, PURSUE THEM RELENTLESSLY AND DEMAND THE MOST SEVERE PENALTIES."

MR. CHAIRMAN, I APPRECIATE THE OPPORTUNITY TO BE HERE TODAY AND AM AVAILABLE FOR TO ANSWER YOUR QUESTIONS.

The CHAIRMAN. Thank you, Mr. Attorney General.

Senator Dixon has joined us and has a statement which he is going to make a part of the record.

Senator DIXON. I thank you, Mr. Chairman.

[Committee insert of Senator Dixon's opening statement follows:]

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee continues its hearings on the thrift crisis. I think this morning's topic—fraud and abuse of thrift institutions by their management—is extremely important. It will take $90 billion, and perhaps even more, to rebuild our savings and loan system, and I think we must do everything we can to see that savings and loan executives that are civilly or criminally liable pay the penalty the law demands.

In 1985, banks and thrifts across the United States lost roughly $46 million to bank robbers. Unfortunately, that is only petty cash compared to some of the looting done with pen, paper, and computer by some savings and loan executives. They were much better thieves than the criminals that used guns to commit their crimes—while it is not yet clear how much of the $90 billion in losses is due to fraud and mismanagement, it seems too clear to me that we are talking about billions and billions of dollars.

This is money that was literally stolen from the savings of ordinary Americans, stolen by the very people they entrusted to keep their money safe. I cannot think of anything more essential to restoring confidence, therefore, than acting to see that these crooks are forced to give up their mansions, their private jets, their limosines, and their lavish lifestyles, and to take up residence where they belong—in a Federal penitentiary.

If we are going to restore respect for the law, civil and criminal violations must be prosecuted vigorously and firmly as a top priority. I have no illusions that we can get most of the wasted and stolen money back, but we will be sending the kind of message that will help ensure we never have this problem again.

I urge our witnesses today to tell us how we can upgrade our efforts in this area. It seems to me that there is sometimes some conflict between the desire of receivers to quickly complete action on an insolvent institution and move on to the next one—especially given the literally hundreds of insolvent institutions out there—and the need to preserve evidence and the option to prosecute potential violations. I think it is vital that the lawyers go into insolvent institutions at the same time as the examiner. We cannot afford, either morally or financially, not to make a maximum effort to see that this kind of white collar crime is not rewarded, and we must see that executives that were negligent and breached their civil duties are fined as appropriate. I look forward to working with my colleagues on the committee, the administration, and all interested parties to see that tough antifraud provisions are part of our legislative response to the thrift crisis.

Thank you, Mr. Chairman.

The CHAIRMAN. And Senator Cranston, do you have a comment?

Senator CRANSTON. Greetings. I think I will not make a statement at this time. I'm delighted you are with us.

The CHAIRMAN. You've raised a number of issues and we will move through some questions here in a rapid order.

Senator Wirth indicated earlier, and I want to pick up on it, that the Washington Post carried an article on February 4 in which it reported that the Federal Home Loan Bank was settling civil cases against S&L executives without consulting the Justice Department and that the settlements undermine the possible criminal prosecution of those executives.

Mr. Robert Bonner, the U.S. attorney in Los Angeles, is quoted as saying—and I quote him directly from that article—"It borders on obstruction of justice. It's mind-boggling."

Are these allegations accurate? If so, what is the Department doing about it?

GRANTING INFORMAL IMMUNITY

Attorney General THORNBURGH. I have asked Mr. Bonner for a full report on the facts set forth in the newspaper article and expect to have that in hand and we'll see that it's furnished to the committee.

I might add that the problem here, if the report is borne out, can be troublesome indeed, as the committee members know. A grant of legal immunity can only under the law be provided pursuant to court order and the applications for grants of immunity are very carefully regulated by the Department of Justice.

Nonetheless, such informal immunity as evidence in the newspaper account, which we are pursuing, can be very troublesome in bringing a case to trial. It can provide a de facto defense to a defendant who can earn the sympathy of the jury by allegations that he had been promised that he would not be prosecuted. And we have made it known in no uncertain terms that any such conduct on the part of regulatory agencies is unauthorized and counterproductive to the effort that's now underway.

The CHAIRMAN. So in the case in which that may have happened, do you still have the legal power to come in and undo that kind of an arrangement?

Attorney General THORNBURGH. Yes, we do, Senator, because the immunity that's granted by informal conveyance from anyone other than the court is not a defense legally to any criminal prosecution. Nonetheless, it is a very difficult case for the prosecutor because on a factual basis certainly a jury's sympathy—rightfully so I think—would be forthcoming to one who had been led to believe that his or her cooperation in seeking to recover funds would buy them a ticket to immunity from Federal prosecution. But that immunity can only be granted under the law by a court order based on an application approved by the Department of Justice.

The CHAIRMAN. So is it fair to say that you have conveyed directly to the regulators that they are not to do any more of that?

Attorney General THORNBURGH. We certainly have made that known in no uncertain terms. Again, I'm uncertain as to the accuracy of the account in the paper. There appears to be some confusion about that. But I've asked Mr. Bonner for a full report on it.

The **Chairman**. But the regulators are certainly clear in their own mind that it's the request of the Attorney General to engage in no such activity without your direct involvement and say so?

Attorney General **Thornburgh**. Let me say that this does not in any event appear to have been a widespread practice. The account in the newspaper is confined to one situation about which we are inquiring. We have no evidence that this has been a widespread practice in the regulatory agencies. Through the bank fraud working group there's been an exchange since its establishment of the ground rules under which referrals and prosecution should be undertaken.

The **Chairman**. You are also testifying today that if you find that action in this case is warranted, regardless of what may have been said by the regulators, you would be prepared to move on it?

Attorney General **Thornburgh**. Well, we would be very concerned if we found that this kind of activity is going on and would take appropriate action, certainly.

The **Chairman**. Mr. Gleeson who is going to testify on our second panel describes for us widespread fraudulent activity in the Texas savings and loan industry. You in your own opening remarks talked about one of the task forces there and some of the efforts that have gone forward.

He is going to indicate to us that the problem is so widespread and he feels—and you'll have to assess his testimony yourself, as will we—that we're just scratching the surface and that there's a much bigger problem out there.

Leaving aside the so-called I-30 cases developed by the U.S. attorney in Dallas, can you again give us the facts on how many convictions we've had that have been achieved by the Justice Department in the entire State and what's pending?

Attorney General **Thornburgh**. I'm not sure I can give it to you for the entire State. Perhaps Mr. Dennis can. The facts that I gave you, the figures, related to the work of the Dallas task force which we regard as an exemplar of the kind of activity that can be undertaken. There have been a number of other cases brought in other districts in the State of Texas by Federal prosecutors and I will see that we give you a full report on those statistics. The statistics that I gave you with regard to the year's operation of the Dallas task force, however, clearly indicate that there's more than enough work to be done there. I have spoken personally with the FBI special agent in charge in Dallas and with the U.S. attorney's office there, and was very concerned about their description of a situation where they are short of personnel of the type that would be provided under the President's suggested program.

So I think swift action and the ability to gear up their operation to the extent that it's necessary to deal with even in the Dallas area the total problem, plus instituting similar operations in the areas that I described where this problem is most acute, would really be a giant step forward in terms of the deterrent capability of effective prosecution.

The **Chairman**. I would just say before yielding to Senator Garn, we are going to provide what you feel you need. Periodically, perhaps every 90 days or so, I'm going to ask that someone come back from the Justice Department and update us as to precisely where we are because this is one aspect that we want to follow closely.

Attorney General THORNBURGH. I think that would be very useful and we would welcome that opportunity.

The CHAIRMAN. Very good.

Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Mr. Attorney General, you've testified that 25 to 30 percent of the losses you estimate are due to fraud or insider abuse and they totaled as much as $2 billion alone last year.

RECOVERING LOSSES

Do you have any rough estimate of how much you think it might be possible to recover of these losses? I obviously can't pin you down to it exactly, but in very general terms, what are the possibilities of recovery?

Attorney General THORNBURGH. It's hard to say because in many cases the assets have been dissipated. In many cases the assets are beyond the reach of U.S. authorities involved in complicated money-laundering schemes that take the assets out of the country. The suggestions contained in the detailed proposal that the President made to increase our capability to seize and forfeit assets that have been diverted into the hands of wrongdoers would enable us to increase the percentage of recoupment.

But I must say to you, Senator, that the recoupment and recovery of these assets is of equal concern to our lawyers and prosecutors in the Department of Justice who are proceeding on the civil side as well as the criminal side, as to the effective prosecution. But I think we would be fooling ourselves to think that any substantial portion of these assets are going to be recovered, notwithstanding our best efforts to do so because of the problems that I indicated.

Senator GARN. Well, I understand that. It's important that we do the best we can, because probably the most controversial part of the President's plan will be how we work out the financing—FICO [Financing Corporation] bonding and all of that—and obviously part of the losses are going to have to be paid by taxpayers where it is beyond the ability of premium income to take care of the problem.

So whatever it is—and I realize all the difficulties of recovery—whatever we can recover from those who stole it, obviously reduces the burden on the taxpayers who had nothing to do with it and no responsibility for these problems taking place. But I understand how difficult it is to even make an estimate at this point.

Attorney General THORNBURGH. I might underscore the importance of the expanded forfeiture provisions that are included in the President's proposal. There is a certain poetic justice in using funds seized from wrongdoers to prosecute yet other wrongdoers and it does have the effect of reducing the overall costs. But it's rather hard to look and give a realistic figure in that regard, but I would commend those portions of the proposal to your attention.

Senator **Garn**. Well, you've heard everybody today in the committee talk about how important it is to give you what assets you need. You have outlined how the $50 million would be used.

In your knowledge of the size of the problem now, is that sufficient? Where did the $50 million figure come from? Do you need more or do you need less or is that the right amount or how does that relate to the size of the problem as you see it now?

Attorney General **Thornburgh**. We have responded to the President's commitment of an additional $50 million by taking a first cut at how we would use those funds. Obviously, in law enforcement, I fear from time to time we sometimes feel that we could use an infinite amount of resources to cope with the problem of crime in our society. But I am satisfied that the $50 million, if forthcoming swiftly and allocated along the lines that I discussed, could have a measurable impact on this problem.

If it appears to be a shortfall of our needs in any dramatic way, we wouldn't hesitate to raise that as well. But I think this would be a very substantial shot in the arm for efforts such as the Dallas task force and its counterparts around the country.

Senator **Garn**. Well, obviously, the reason I asked the question is that it's popular to be against waste, fraud, and abuse and criminals and all of that, and we all are—whatever you need, we'll be happy to give you. But having made that statement, sometimes we all throw money at a problem, because it's popular to do so, beyond the ability to absorb and use that money efficiently. So I think a fair assessment of our statement would be to give you as much as you can beneficially use.

Let me ask you one other question. Over the last few weeks there have been newspaper accounts about some of the big eight accounting firms and their auditing responsibilities and at least alleged charges that there may have been some collusion involved there.

What is the responsibility of outside auditors to detect fraud?

Attorney General **Thornburgh**. Well, I think it's important to distinguish what professional obligations and what civil liability might be involved for auditing firms and the level of criminal responsibility that might attach for these types of activities.

To my knowledge, thus far, investigations carried out by the Department of Justice have not indicated any criminal involvement on the part of accounting firms. And I have received the same accounts that you have of allegations of negligence or a failure to fulfill professional responsibilities.

So saying, however, I can assure the Senator that if in the course of these investigations the evidence leads to wrongdoing on the part of any individual, we will not hesitate to pursue it.

Senator **Garn**. Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Garn.

We have been joined by Senators Sarbanes, Bryan, and Sasser. Senators Bryan and Sasser have statements to be included in the record.

[Committee insert of Senators Bryan's and Sasser's opening statements follow:]

OPENING STATEMENT OF SENATOR RICHARD BRYAN

Senator BRYAN. Mr. Chairman, let me commend you on scheduling this most important hearing on the topic of fraud in the savings and loan industry.

We are going to ask the American taxpayer to foot the bill for the crisis that has developed in our savings and loan deposit insurance system. I understand that fraud was involved in up to 25 or 30 percent of these insolvencies. Management in many of these failed thrifts is largely responsible and in many cases personally benefited from transactions that contributed to their downfall.

Certain States that granted their savings institutions powers to engage in everything from land speculation to high-risk options trades should also be held accountable. Before we ask our citizens to pick up this tab, I must be assured that we are doing everything in our power to seek out and punish those that have committed fraud. We must make every effort to recover assets diverted from S&L's and place behind bars those who have caused losses through criminal behavior.

I look forward to hearing from the Attorney General on the steps his Department is taking to combat this problem and will cooperate as best I can in crafting legislation to insure this doesn't happen again.

Thank you, Mr. Chairman.

STATEMENT OF SENATOR JIM SASSER

Senator SASSER. I am pleased that the committee is reviewing the issue of pervasive fraud in the savings and loan industry. And I am pleased that the Attorney General is here today to tell us about the Justice Department's progress in this area. I must say, that by all reports the Department has not been too successful.

Contrary to what the regulators told us before, the GAO says that fraud and insider abuse is a major reason for the losses suffered by the FSLIC. The GAO reviewed the books at 26 failed S&L's and found fraud in every single one.

We will hear today from witnesses who will tell us why this situation could continue to exist with the knowledge of nearly everyone in the community except the regulators. Indeed, the lack of response from the regulators to serious and often criminal misconduct sent a signal to others that they too could get away with it.

We've heard of the likes of housepainters, with no financial experience that were permitted to gain control of federally insured S&L's. After a few months, in the business the house painter had a fleet of Rolls Royces—and paid for by the S&L. Now, the S&L is down the tubes, and the FSLIC is holding the bag.

The story is one of countless "land flips," where properties were sold and resold—often many times in one day. Each time the property was sold it was at a dramatically higher price—care of a likely fraudulent appraisal.

The continual aggressive, unrealistic lending by savings and loans drove prices up to a point where they had to crash. It may not be the decline of oil prices that brought the Texas economy down as much as unregulated and fraudulent lending by S&L's.

This is a serious situation—it requires the dedication of our law enforcement officials. It's disturbing, when we're told that just a few months ago Attorney General Meese took $1 million away from the special financial fraud task force and reallocated it to his antipornography program. That's foolish, illogical and an absolute waste of the taxpayers money.

Mr. Chairman, we should be spending our money to get money back from those that defrauded the Government before we ask the taxpayers to contribute one more nickel.

And we should go after them for whatever we can get them for. The FBI got Al Capone for tax evasion, not fraud or racketeering. If that's a likelier way to recover funds, we should pursue it.

We should change the law to make it easier too. The amount of money involved is too high, and the criminal activity too widespread, for us not to put maximum effort into this.

Thank you, Mr. Chairman.

The **CHAIRMAN**. Senator Wirth.

Senator **WIRTH**. Thank you, Mr. Chairman.

Does the Justice Department keep a record of the successful prosecutions in the S&L industry?

Attorney General **THORNBURGH**. We have from each of the U.S. attorneys and from the fraud section of the Criminal Division those records. I don't know that they have been compiled in any one volume, but we could do that for any time period that would be appropriate.

Senator **WIRTH**. Is that something that would be helpful to do, to take a look at that? The same Washington Post article says:

> Neither the Justice Department nor the FBI keeps a record of successful prosecutions in the S&L cases, but according to the Bank Board, 172 officers, executives, consultants and borrowers have been convicted from 1983 through 1988.

Attorney General **THORNBURGH**. I wouldn't quarrel with those figures and we can provide the committee with whatever other figures might be useful.

Senator **WIRTH**. It seems to me that keeping a record of this would be important because that leads to the next question.

IDENTIFYING REPEAT OFFENDERS

One of the concerns that I think a lot of people have is here these guys are maybe operating in one State and they make off with the bank there and they go across the river and start all over again. One of the concerns that I have is how do you go about and is it possible to draft a law in such a way that anybody who has been involved in defrauding a federally insured institution is precluded from ever being involved again? Now some draconian measure—not draconian measure, but common sense measure, not dissimilar from what we do in insider trading—you get convicted of that three times comes back.

Attorney General **THORNBURGH**. That is included in the President's proposal and I might say that through the bank fraud working group the case tracking system that I spoke of in my testimony was designed to identify the repeat offender and there are a good many of those mobile operators, if you will, who will carry out their schemes in one State after another. And I think there's a very clear tracking system available to both the regulatory agencies and the Department of Justice to identify those individuals.

Senator WIRTH. How does that jibe with your earlier statement that you don't keep a record of who's been prosecuted?

Attorney General THORNBURGH. It isn't a matter of not keeping records. I just couldn't give you off the top of my head the numbers.

Senator WIRTH. OK.

Attorney General THORNBURGH. Through this tracking system there's a very tight monitoring of what the movement of these types of cases are in terms of specific individuals. I didn't mean to leave that impression. What I just don't have at my fingertips is the statistics on the number of convictions because they come from 94 U.S. attorneys' offices and throughout our division. We can get those figures for you.

Senator WIRTH. That was my softball question to you to point out that the President is concerned about this, it's in his proposal, and so on, and yes, indeed, we're going to track those people and not only are we going to try to pursue that fraud but they are never going to get involved again and we're going to do everything we can to preclude them from being involved.

Attorney General THORNBURGH. The proposal as I recall contains more stringent provisions to prevent reentry. Presently, my understanding is that reentry into the business is only with respect to the defrauded institution, which really takes a pretty dumb criminal to do. This is going to reach those who are a little smarter who would go into another institution. And that seems to me to be one of the more obvious common sense changes in the law.

Senator WIRTH. Is there any way of getting a record on the people who were involved in defrauded institutions who came back to the FSLIC with a proposal for refinancing and so on?

Attorney General THORNBURGH. I will seek that from the bank fraud working group.

Senator WIRTH. I would think you would want to look at that because it's my information that in fact a number of these guys have gone out and tried to put together a new package of financing and come right back into the FSLIC and the Bank Board has had no record as to who these people are and we've seen some of these guys coming right back in again. Having done it once, they are back in trying to get Uncle Sam to give them some good healthy tax breaks maybe to cover their ill-gotten gains and the taxes they might have to pay on those.

Attorney General THORNBURGH. I expect that would be available from the working group and I will certainly inquire.

Senator WIRTH. Have you all met with the General Accounting Office? Mr. Wolf of the General Accounting Office has done this very extensive report on fraud within the S&L industry. I can only assume that your people are working with them.

Attorney General THORNBURGH. I have not personally met with him, but people in the Department routinely review with the GAO the products of their investigations and I can only assume that in an area like this about which we have considerable concern that would be the case.

Senator WIRTH. I just want to make sure that that has happened. They've been up testifying in front of us. They've been looking at this for some period of time and have been very helpful.

Just a final question on the numbers to make sure that the record is clear on that. You suggested, as I remember your testimony, that there are 25 to 30 percent of the institutions involved in fraud and that that might lead to the recovery of $2 billion. Is that correct?

Attorney General THORNBURGH. The $2 billion figure is the estimated loss to savings and loan and other financial institutions in the year 1988 that was connected with fraud or embezzlement or insider abuse. How much of that could be recovered, I wouldn't want to estimate. But that's the estimated figure of the loss during the last calendar year.

The CHAIRMAN. How do those figures jibe when the overall loss in the S&L industry is in the neighborhood of $50 to $100 billion.

Attorney General THORNBURGH. Not in 1 year, though. This is only 1988. The $2 billion is from 1988 and that, then, I guess, if my arithmetic is correct, if that is indeed conservatively estimated to be 25 to 30 percent of the total loss, that would make the total loss somewhere around $8 or $10 billion.

Senator WIRTH. $8 or $10 billion, and I think you ought to look at that because those figures don't quite add up. If 1988 was the worst year and you're suggesting it's only $8 to $10 billion of loss——

Attorney General THORNBURGH. I wouldn't want to certify those figures. I'd end up like one of Senator Garn's accountants I think, but I will—those are conservative estimates that come from our people.

Senator WIRTH. I think you've got a good proposal and we appreciate your being here. Thank you very much.

The CHAIRMAN. Before I yield to Senator D'Amato, if I may just briefly ask you on that very point, I take it that you feel that you can probably recover some amount greater than the $50 million that it's going to cost you to add agents. I would hope you would feel you could go out and recover some amount larger than that. Do you have a view on that?

Attorney General THORNBURGH. That's a tough call. I'd hate to give you a firm assurance on that. I can assure you that we will, given the increased resources, be able to pursue a lot more in civil actions, if the forfeiture provisions are included in the law, through those kind of proceedings than we can presently. But I would be hard pressed to give you a firm figure on what those recoveries would be because it's difficult to know in a hypothetical case how much of those assets have been dissipated, how much has been spirited away through money-laundering operations. But we will make a best effort.

The CHAIRMAN. Well, I sure hope you're going to track them down. I don't care where you have to go to get the money, if it's out there to be gotten, I hope you will attempt to get it.

Senator D'Amato.

Senator D'AMATO. Mr. Chairman, on that line, let me commend the Attorney General because they have been having some extraordinary successes in the forfeiture clause. I believe in one case developed between Rhode Island and Long Island, one individual, you're in the process of collecting something in excess of $50 million. So I would say, if there's anyone who can do it, Dick Thornburgh and his people are committed. And generally, in these cases where we do give them sufficient resources, they have as a rule, through forfeitures and seeking out cases like this, been able to do more than offset the cost. Obviously, the Attorney General can't make a guarantee for that.

Let me say, Mr. Chairman, I am tremendously heartened by the presentation of the Attorney General today. I think he has set forth the manner in which he is going to pursue this with all due diligence and I think he must be heartened by hearing the commitment of this committee and its members to be of assistance in this very important undertaking because it's keeping faith with our American citizens that we are not going to just close our eyes and say, well, it's gone, it's lost; we're going to pursue the perpetrators and we're going to obviously attempt to recover as much as possible.

So, Mr. Attorney General, let me wish you the best of luck and I know we have your commitment in this area and you recognize the sensitivity and the importance of it.

The CHAIRMAN. Thank you.

Senator Graham of Florida.

Senator GRAHAM. Thank you, Mr. Chairman.

Mr. Chairman, I am very impressed with the outline of action which the Attorney General has presented and impressed with his personal as well as the President's commitment to see that it's carried out.

I am concerned, however, that we are doing so out of a background that raises questions about our sustained commitment.

One of those questions is the fact that last year per the testimony of the people who were brought to trial by the task force, we only collected $133,000 of fines and $2.8 million in restitution which has been ordered, of which less than $600,000 went to FSLIC.

Applying your standard of the amount of fraud induced loss in 1988, how much fraud induced loss had been estimated to have been applicable to those cases which were tried through the task force as set forth on page 6 of your testimony?

Attorney General THORNBURGH. I don't have that data but I can certainly supply it to you, Senator.

Senator GRAHAM. Would you think that would be representative of the kind of percentage of potential recovery that we might get with those cases? Did they have any peculiar circumstances?

Attorney General THORNBURGH. It's hard to say because obviously the amount of the fine is within the discretion of the court. Now that the sentencing guidelines have been upheld and we will have that enhanced tool available, I think we will have a more definite structure within which to look at the size of the fines.

Moreover, the use of civil actions as a correlative to criminal prosecution will depend again on the resources that are available to levy upon a criminal defendant in a civil action and the difficulty of seeking out those assets that I referred to earlier in my testimony.

EXPANDED FORFEITURE PROVISIONS

I do want to reiterate for a third time, perhaps for additional emphasis, the importance of expanded forfeiture provisions which enable more expeditious seizure and conversion into assets that can be utilized to repay the institution or FSLIC, as the case may be, in a way that will greatly enhance the dollars and cents side of our undertaking.

But it is hard to generalize because each case has its own peculiar features, both in terms of the sentencing prior to the guidelines and the availability of assets upon which to levy. In fact, my guess would be that you would find some of the largest losses in cases where no assets exist to levy upon. They have been totally dissipated in the kinds of activities which the committee is well familiar with.

On the other hand, in the smaller cases, the process of recovering those gains when they are available is much more arduous because you have a smaller pot to draw from. But again, you've touched on what I think is a very important point that your colleagues have noted and that is the importance of not being satisfied simply with criminal prosecution and the recoupment through civil actions, fines, and if the forfeiture provisions are forthcoming, aggressive use of them, I think you can go some of the way toward providing some relief in the financing of these efforts.

Senator GRAHAM. The chairman made reference to the report on CPA's. That's one group of ancillary entities affected by this question of abuse. Another are those who benefited directly from transactions. A real estate developer who, in collusion with an S&L official, using an artificially inflated appraisal received a loan which has now gone bad and contributed to the downfall of the institution.

Are those ancillary individuals—that is, they are not direct employees or officers of the institutions—also going to be an object of this fraud assault?

Attorney General THORNBURGH. Yes. They would be prosecutable as accessories or where the facts and evidence justify under conspiracy laws, if those cases can be proved. I think the intent here is clearly to cast as wide a net as possible where wrongdoing can be established.

Senator GRAHAM. If we are back together 24 months from now receiving an evaluation of the first 2 years of this intensive fraud effort, what would you like us to use as the report card, the standard of your success or failure, with as much quantification of that report card as possible?

Attorney General THORNBURGH. I would hope that in that timeframe we would be able to report to you that we had provided, first of all, to the Dallas task force the resources that they need on an expedited basis to complete their work, which is the first of the efforts that we've undertaken of this type.

Second, that we had been able to use the lessons developed out of the Dallas task force to replicate its operations in other centers of activity and that a substantial number of those who have been involved in these criminal activities have been prosecuted and convicted and that significant sentences have been imposed upon them and that using the criminal fine mechanism, civil actions, to recover, and if the forfeiture provisions are forthcoming, to return a significant amount to institutions or to FSLIC or other agencies of the Government that have been wronged by these activities. And that the public has been reassured that not only has there been activity in other spheres encompassed within the President's proposal to shore up the financial stability of existing savings and loans but a much higher level of deterrence has been built into our criminal justice system to ensure that others aren't tempted to repeat what has been tried, unfortunately sometimes successfully, in the past. And I would hope that we would have a statistical record that would bear out the achievement of each of those goals.

Senator GRAHAM. Thank you. Mr. Chairman, if the Attorney General would care to supplement in writing what those standards are so that we will be evaluating you against standards that you consider to be reasonable and standards that can be measured with as much precision as possible.

Attorney General THORNBURGH. I'd be glad to.

Senator GRAHAM. Thank you.

The CHAIRMAN. Thank you. We will have you provide that for the record.

We've been joined by Senator Shelby and he has a statement.

Senator SHELBY. Mr. Chairman, thank you. I have a statement for the record that I would like to be made a part of and I will defer until my time on the questions. Thank you.

The CHAIRMAN. Thank you. So ordered.

[Committee insert of Senator Shelby's opening statement follows:]

STATEMENT OF SENATOR RICHARD SHELBY

Senator SHELBY. Mr. Chairman, I commend you for scheduling this hearing on fraud in the thrift industry. As the analysis of the S&L crisis continues and the estimates of the clean up costs continue to rise, more and more of my constituents are demanding to know where all the money went.

Danny Wall has indicated that 20 percent of the thrifts that fail have failed as a direct result of fraud, while the House Government Operations Subcommittee has found that in the failure of as many as 75 percent of thrifts, fraud was a factor. These figures are astounding.

As Mr. Gleeson notes in his testimony, the asset base of Texas S&L's grew by 250 percent from 1982 to 1986. While I realize that everything in Texas is big, growth of this magnitude sends a loud signal. However, what we had in place was a system that was trying not to hear.

One of the checks in the system, the independent auditor, has recently been found to have failed quite frequently. The GAO report finds that 6 out of 11 audits by certified public accountants were inadequately or unprofessionally conducted. Mr. Chairman, everyone makes mistakes from time to time, but I find it highly unusual that 55 percent of the audits conducted by professionals that make their living conducting audits, failed to turn up the problems that later emerged. The GAO finds the shortcomings of these auditors sufficient to warrant referral for regulatory review; I believe that some of the $50 million to go to Justice for additional investigation should be used to examine the faults of these auditors more carefully. If the intent to defraud cannot be proven, negligence and unprofessionalism probably can. I believe that, at a minimum, these accounting firms should make restitution of their fees.

I am not going to address the failure of the State examiners. The size of the problems that are concentrated to just a few Southwestern and Western States make it clear that the State examiners were either unable or unwilling to do their jobs.

It is the Federal regulator who bears the greatest responsibility. While countless indicators were screaming for attention, the Federal Home Loan Bank Board continued its game of hear no evil, see no evil, speak no evil. To be fair, they asked the Office of Management and Budget for more money for more regulations. And they got very little assistance in response. In retrospect, we see that was shortsighted and irresponsible of OMB. However, the responsibility lies with the Bank Board. They had figures of the tremendous asset growth of Texas thrifts. They saw hordes of new players entering the thrift industry. They sanctioned the requests for additional activities, they approved accounting practices which were in reality little more than smoke and mirrors.

Mr. Chairman, we in the 49 other States find Texans amusing and refreshing for their continuous optimism and their grandiose ideas. The spirit of the frontier remains alive and well among the steel and glass towers of Houston and Dallas. That spirit is infectious and those of us who are fortunate enough to spend much time around our Texan friends find ourselves caught up in the enthusiasm and optimism, as well.

However, our Federal regulators were not paid to play Pollyanna. They were there to be the wet blanket, to rain on the parade, to poke holes in every windbag of ideas. And they did not do it.

Hindsight is 20/20. We can point fingers all day long but the fact remains that we have a big problem to clean up. I want to see the Justice Department prosecute those who defrauded the industry to the fullest extent possible. I support stiffer penalties and maximum fines. I want us to recover every penny possible and return it to the taxpayer.

But our most important objective is to ensure that regulatory failure of this magnitude never, never happens again.

Accomplishing this objective is at least as important as finding the $100 billion it's going to take to fill this hole. I believe that some of what we hear today will assist us in laying the goundrules for future, tighter regulation.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

Mr. Attorney General, there's been a lot of publicity of late about the use of the very powerful tool RICO [Racketeer Influenced and Corruption Organization Act] in the prosecution of insider trading cases.

Can the Justice Department use the Racketeering Act to prosecute bank fraud? If so, will you use it? If not, why can't you?

USE OF RICO TO PROSECUTE BANK FRAUD

Attorney General THORNBURGH. It is presently a predicate for—that is, bank fraud and embezzlement for use of the RICO statute and it has been used and I think Mr. Dennis could probably give you some examples of where that may have been carried out.

Senator HEINZ. My understanding is that wire fraud and mail fraud are predicates. I'm not sure that bank fraud is a predicate, but I've got the Nation's two best lawyers there and I suspect you know better than I.

If it is a predicate, as you say, is it a useful tool and will you use it?

Attorney General THORNBURGH. It is a useful tool. There's no question about that. And I will try to be more precise. Certainly wire fraud and mail fraud are often the most used statutes in these types of cases and they clearly are predicates for the RICO statute and the examples of the types of cases that have used the RICO statute are wire fraud cases. So they are presently predicates for the use of the RICO statute.

Senator HEINZ. There's a little confusion on the issue of whether bank fraud is a predicate. It may not be because our bank fraud law was written rather more recently.

Let me put it this way. If bank fraud isn't a predicate offense, would you favor amending RICO to make bank fraud a predicate offense?

Attorney General THORNBURGH. I would have to look at that a little more carefully, but I think that certainly in these types of cases the use of the RICO statute would be and has proven to be useful. Whether that's a shortcoming in the present statute or not, I don't know.

Senator HEINZ. Are there any other changes in the criminal law that you would like in order to help prevent or eradicate bank fraud?

Attorney General THORNBURGH. The President's proposal set forth a number of changes, some of which I have mentioned already, one of which would raise the disqualification provisions to reach other financial institutions.

Senator HEINZ. That's on the prevention of reentry into the industry. We were talking about that earlier, right?

Attorney General THORNBURGH. Yes. The proposal to increase penalties under the criminal statutes which would increase the maximum term for most bank crimes to 20 years, and the addition—here's what I was thinking about—let me get back to RICO a second, because by inadvertence or an oversight apparently banks and not savings and loans fraud is a predicate for the RICO statute. That's where the confusion comes about. So that's part of the President's proposal is to add savings and loans to the application as a RICO statute.

Money-laundering provisions are recommended to be extended to these types of cases. Money-laundering statutes which enable us to pursue and seize funds that have been passed through various transactions designed to disguise them as legitimate transactions.

Senator HEINZ. Just to flush out the record on the S&L fraud, can you anticipate there would be instances where the application of a RICO amendment, as the President proposes, would assist you and your prosecutors in really getting to the core of some of the misappropriation abuses.

Attorney General THORNBURGH. Yes, I think in prosecuting the case you want to have the biggest arsenal of weaponry available. I think in most of these cases mail fraud and wire fraud statutes as substantive offenses or as predicates for RICO are sufficient. But clearly misappropriation of bank funds but not S&L funds creates a gap in that sense. This is on a normal embezzlement count. So I think to that extent it would be useful to cure that oversight.

Senator HEINZ. Thank you.

The CHAIRMAN. Thank you very much, Senator Heinz.

Senator Dixon.

Senator DIXON. General Thornburgh, first of all, let me thank you for your useful testimony before the committee this morning and I know I speak for the entire committee when I say we congratulate you for your efforts to pursue fraud and corruption and things of that character in the thrift industry and the financial industry generally. And you are to be commended for that.

I want to talk about a subject that's not nearly as exciting but may be a thing worth discussing in view of the nature of the cost of this problem to the American taxpayer.

We are talking about something here that ranges anywhere from $50 to $100 billion. My recollection, Mr. Chairman, is that when some of the leadership on our side met with Secretary Brady he indicated it was at least $75 to $80 billion. That's a lot of money.

In my other life, in my career years ago in the 1960's, I served on the board of directors of a major bank, a major financial institution in southern Illinois, and I remember while serving on that board of directors that when we discussed major investments we agonized a lot about the reasonable prudent man rule and a lot of case law about the liability of officers and members of boards of directors and leading executives in financial institutions, their personal liability, General, regarding investments of the funds that they handled as trustees for people who put their funds in their financial institutions.

Now a lot of this is fraud and corruption. I suspect in those cases most of those rascals have empty pockets by the time you get to them. A lot of them do at least. Now you are to be congratulated for pursuing them all. I hope you put them all in jail. I hope you get every dollar you can get from them.

What about all of the dumb investments, the negligent investments, the investments made around the country clearly comprising billions and billions and billions of dollars of the invested funds of ordinary people in America that in my view would violate the reasonable prudent man rule?

REASONABLY PRUDENT MAN RULE

Do we have a civil division under your authority or elsewhere in the Government that's looking at that? There have to be a lot of people still walking around with deep pockets and substantial financial net worth statements that were involved in a lot of these investments around the country that would be liable under the reasonably prudent man rule.

Now I presume there's a lot of insurance policies and fidelity bonds and other things protecting them and before the taxpayers—I don't want to say before because I am prepared, Mr. Chairman, in the appropriate manner and at the proper time to support the general parameters of what the administration has asked for reserving to myself the right to work on it a little bit here in this committee—but are we prepared to look at that kind of thing and are people in the administration looking at it now? That has to be broad-based. That has to involve a lot of other billions we haven't talked about here.

Attorney General THORNBURGH. Obviously, where the United States is an aggrieved party, the individuals of the type that you identify are subject to civil actions to recover for civil wrongdoing. That is other than criminal prosecution where negligence or failure to observe proper standards, as you know, has not been observed.

The problem you note, however, is oftentimes the prospects of recovery by execution of any judgments that have been obtained are somewhat less than heartening because of the dissipation of those assets.

But I agree with you that in those cases where substantial judgments can be obtained they ought to be and will be pursued vigorously because we regard the recovery of moneys that have been improperly accumulated by those who had the stewardship of these financial institutions to be almost as important as the responsibility on the criminal side. I say almost because I think the deterrent capability of a criminal prosecution has always been greater than that of a civil action.

Senator DIXON. Well, Mr. Chairman, I don't want to belabor this unnecessarily, but I would want to confess that I'm a little behind the curve on what the civil law is with respect to this now. I am talking about my personal experience of almost a quarter of a century ago as a member of a board of directors and again I would reiterate that.

Attorney General THORNBURGH. The statutes have run out on whatever you did.

Senator DIXON. I understand that, but I remember how we agonized about whether we were making an intelligent investment and whether we were being reasonably prudent men and other things.

I wonder if you could develop for this committee what we can do to civilly pursue not just the rascals and the scoundrels and the thieves but reputable people involved as executives, members of boards of directors and other things of financial institutions who made bad investments make them make good civilly their liability for that to reduce the otherwise expensive load the taxpayer will have to bear and would you also make available to us if you could through your shop and the best expertise you have there suggestions about things we might do with the law, not just on the criminal side? I suspect the criminal laws are already adequate. I don't know that, but I suspect it. But what we might do on the civil side to throw out a larger net and bring in more money from people who ought to be responsible for it before we make taxpayers and others pay the expense? Could we get that kind of information from your shop?

Attorney General THORNBURGH. You certainly can. As part of our overall effort, our civil division which handles these matters is developing a legislative package and began development before this came along, and I think that's timely. When that's completed we will furnish that to you for your suggestions and observations.

Senator DIXON. I think that would be very helpful. I thank you.

The CHAIRMAN. Let me just say, Senator Dixon, I think that's an excellent line of questioning. The data that we have indicates that FSLIC is now recovering $2.50 for every $1 that they are spending on their civil litigations. That looks to me like a pretty good return on investment, and I suspect that there are probably billions of dollars out there. You've got to work awfully hard to get it, and the people who have made off with it through negligence or malfeasance are going to fight very hard to keep it, but I agree with you completely. It may well be what we want to do is bring the civil prosecutions over into the Justice Department. I think that's worth talking about here. I realize you have a lot of other things to do, but you're going to do an ad hoc effort with the $50 million. It seems to me that you may want to consider the possibility of taking on the civil thrust of this thing to go out and get this money.

Senator DIXON. Good. I thank the Chair.

The CHAIRMAN. I don't want to trespass further on the time of Senator Bond.

Senator GARN. To follow this up, Senator Dixon, you may or may not remember that in S. 1886 we covered some of this in that area and you reintroduced that bill, so we were looking at this last year as part of that legislation.

Also, along the line the chairman was mentioning, Mr. Attorney General, I understand why you have to be cautious about what you think you can recover, but I think I could guarantee you that you will recover $50 million. The chairman pointed out $2.50 for each $1, but here's a story in the Washington Post where the Federal Home Loan Bank Board recovered $50 million last August from one deal. So I understand why you are overly cautious, but I think you're going to recover far more than $50 million because this was from a law firm who advised an S&L and the Federal Home Loan Bank Board got a settlement of $50 million out of one law firm.

With the billions you've got out there you're going to more than get your $50 million back.

Attorney General THORNBURGH. Nothing would please me more than to return a healthy dividend to this committee and to Congress if we get the $50 million.

Senator GARN. I think there is evidence that one case got $50 million last August.

Attorney General THORNBURGH. Let me just add, in connection with S. 1886, let me just commend to this committee's attention with regard to some of the enhanced penalties and enhanced capabilities for recovery in civil actions. That is something that we have worked with the committee on and with the Senators on and we hope that that will be ripe for early consideration.

Senator **Dixon**. And we would encourage your suggestions for enlarging opportunities under that bill, too.

The **Chairman**. Let me just say Senator Bond was a State auditor and worked for the Attorney General and has really taken the lead very substantially in this area. So, it's appropriate that we yield to him at this point.

Senator **Dixon**. He was a Governor once, too.

Senator **Bond**. Thank you, Mr. Chairman.

Unfortunately, I don't have experience in auditing financial institutions so I'll have to defer to our Pennsylvania experts who know more about the criminal prosecution.

Dick, I'd like to ask you just for a moment to focus on a broader question of philosophy. We have talked a lot about details, but the materials compiled by our excellent Senate Banking staff includes a November 8, 1987 Dallas Morning News article in it and I was struck by the fact that in 1985 there were 5,995 robberies of U.S. financial institutions. The total amount involved was $46 million. Nobody has a problem sending bank robbers to jail. Then compare that to one San Diego area savings and loan association which lost $70 million in a single series of criminal prosecutions.

You noted in your testimony that of the 12 defendants sentenced, 4 were placed on probation. One of them did get 35 years. But most of them, the rest of the 8, were imprisoned 6 months to 1 year.

What do you think about the sentencing? What do you think about the deterrent effect? What's your philosophy with respect to criminal prosecution of white collar criminals?

CRIMINAL PROSECUTION OF WHITE COLLAR CRIMINALS

Attorney General **Thornburgh**. Well, we are examining in connection with this review process the sentencing guidelines that have been validated by the Supreme Court in the *Mistretta* case to ensure that there are suitable sanctions imposed in these types of cases.

My own belief is that we ought to be looking at very severe penalties that relate to the amount of harm that's been inflicted not only on the particular institution but on the industry as a whole. So it is a broader field that we have to look at than simply the individual case that's involved.

A judge of my recollection, in passing a stiff sentence on a white collar defendant, said that our law must be not only color blind but collar blind, and that stiff sentences for white collar criminals have a particular impact on the type of defendant that appears before the court in these types of cases. They value their reputations, sometimes gained under false guises. They value their standing in the community to which they are not entitled by reason of these kinds of wrongful acts. And more and more the theory behind sentencing in these cases is toward jail time, toward heavy fines to the extent the resources are available to go some part of the way toward restoring the integrity of the institutions that they have ripped off, and I quite agree with the Senator that in the application of the sentencing guidelines we ought to be assiduous in seeing that appropriate stiff sentences are forthcoming in these cases because they have, as President Bush noted in his commitment to strong prosecution of white collar crimes, more than an episodic effect on the quality of life in our society. They have a tendency to undermine the integrity and credibility of very important financial and economic institutions in this country.

Senator BOND. Well, I value your judgment and I certainly appreciate your clear statement.

It would seem to me that hard time in jail is a very healthy antidote and a very good example to deter others, in addition to providing the vengeance of which we have spoken earlier.

Attorney General THORNBURGH. They say with respect to crime on the streets, Senator, if you can't do the time, don't do the crime. And I think the same kind of message ought to go out with respect to crime in the suites as well.

Senator BOND. One quick question in the time remaining. You talked about the bank fraud working group. Do you need a legislative mandate for that? Is there anything to do? Mr. Dennis is shaking his head.

Attorney General THORNBURGH. I don't need to look at him.

Senator BOND. Is there anything we need to do by way of legislation? We don't want to interfere with it. Is there any kind of legislative support that we can give that will help you rather than hinder your operation?

Attorney General THORNBURGH. I don't think so. It's been very useful over the last 3 or 4 years in increasing the ability of us to see that the whole is greater than the sum of the parts in bringing these different groups that have regulatory, prosecutive, and civil responsibilities together to work in one combined effort.

Senator BOND. Thank you, sir. I look forward to pursuing the subject with you later.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bond.

Senator Cranston.

Senator CRANSTON. General, do you have any concept of what percentage of the overall problem we face, of $100 billion or whatever it is, is due to fraud and criminal acts and how much is due to other factors like deregulation, adverse economic conditions, rising interest rates, falling oil prices, and so forth?

Attorney General THORNBURGH. I would leave it to the economists to either enlighten or confuse you with respect to those last two or three elements, but our best estimate is that a material contribution was made to losses in some 25 to 30 percent of the cases.

Now it's often difficult to assess because there are a lot of contributing factors in the failure of an individual institution. Clearly, the economy in some sections of the country has—I'm sure in some cases it has been the sole cause of a failure. In other cases, mismanagement, negligence, inattention to duties, the types of things that Senator Dixon mentioned in failure to abide by the prudent man rule in making investments.

At the other extreme, there are clearly institutions where it is without doubt active criminal activity, fraud, conspiracy, embezzlement, misappropriation of funds, that has been the primary source of the failure of the institution or its loss to the extent that it had to be taken over.

Senator **Cranston**. Much of the fraud that has occurred has only really been discovered when there's an insolvency and then there's an analysis of what went wrong.

Attorney General **Thornburgh**. Right.

Senator **Cranston**. I presume in some instances in thrifts that are still in business that some of the same sort of thing is still going on. Again, it's not likely to be discovered until there's some sort of a disaster either in a locality or in an institution.

Do you have any thoughts on any measures that could serve as an early warning signal in detection of such activities before they get out of hand or before they cause an insolvency?

EARLY DETECTION OF IMPROPER ACTIVITIES

Attorney General **Thornburgh**. I think that one of the advantages of a more aggressive prosecution of wrongdoing is the discovery and development of patterns that take place within these schemes to defraud the institutions and the sharing of that with this body and with the regulatory agencies in the form of suggestions as to how more deterrent capability could be built into the regulatory structure is a useful byproduct that we hope to realize from a more aggressive effort.

Right now, I would be hard pressed to lay out specifics, but one of the advantages of the bank fraud interagency working group has been that there's a constant interchange between prosecutors and regulators with respect to these kinds of actions that might be taken. And I think that it is extremely important to look from our point of view not only at each case, case-by-case in terms of prosecution and civil recovery, but to develop our own instincts and share them with the regulatory agencies as to what kind of peril points and danger signals can flag a greater level of interest in a particular institution.

Senator **Cranston**. Thank you very much. I want to join in stating what some of my colleagues have said that if you need any more resources don't hesitate and please do let us know as well as the President and OMB.

The **Chairman**. Thank you.

Senator Gramm.

Senator **Gramm**. Mr. Chairman, let me thank you. Mr. Attorney General, again, we are glad to have you here. I hope that as you intensify your effort you will use our U.S. attorney in the northern district of Texas. Marvin Collins is a Texas lawman in the best tradition of the Texas Rangers and other legendary lawmen in our State.

Attorney General **Thornburgh**. One savings and loan failure, one U.S. attorney. Is that what they say, Senator?

Senator **Gramm**. For those who don't know the story the Attorney General alluded to, there is a famous story about a riot in Fort Worth. The mayor sent a frantic telegram to Austin, saying, "Massive riot, send Texas Rangers." So into town rode one lonely ranger. The mayor and the city council met him at the city limits and said, "What's this? We've got civil insurrection here. We wired for the Texas Rangers." So the ranger looked at him and said, "One riot, one ranger." He then rode into town, and the first rioter he saw he shot right between the eyes with his 44-40, and that was the end of the riot.

So Marvin Collins does not need many bullets, just a few.

Mr. Attorney General, I want to join everybody else here. I guess my frustration is, as strongly as we feel about the defrauding of the public interests that's occurred, the plain truth is that the real crooks have long since left the savings and loan business and are now out in other pursuits. I think it's vitally important that we do everything we can to recover every cent. I don't have any idea how much is there, how much of the loss came from inflation, how much came from interest rates, but I think it's very important that the American people have confidence that we are not going to let people that have abused the public trust simply walk away with great amounts of money. I urge you to do everything you can to pursue that money through the grave, around the corner, however we can do it.

I think that other than a few experienced people here in this area, like Senator Bond, who is really the leader on this issue, most of us are frustrated. We are committed to trying to help you, but the truth is that we don't know how to go about it. So I want to join my colleagues here that have asked you to give us any suggestions as to what we can do in terms of changing the law, in terms of providing more resources, anything we can do to help you in this effort, whether it makes money or not. Obviously I believe that if the Lord's work can be done at a profit it will always be done with greater alacrity and attention. But anything we can do to help, please call on us, because I think there's a universal commitment on this committee that while we are shelling out all this money, while we are digging out of this hole, that we not only close the barn door to be sure that no other horse gets out in the future, but we want to try and go back and get those that are really responsible. I agree with our chairman, we are not talking about the vast number of people, most people, in the savings and loan business who are honorable people trying to do a good job.

Many people have come into the old institutions, and when the crooks left they came in and tried to pick up the pieces. But I think it is very important that the public perceive and perceive correctly that we are trying to pursue the people who caused the problem and pursue these ill-gotten assets. So please call on us, because we are going to write a bill here. We are going to do it in short order I hope, and I believe we will, and this is a golden opportunity to change the law in such a way as to help you go after white collar criminals, especially those involved in financial areas. And since it's very hard for us to act legislatively, I hope you won't miss this train. Anything that you think ought to be in it, please call on us and give us an opportunity to give you the extra silver bullet you need to get the job done.

The CHAIRMAN. Thank you, Senator Gramm.

Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Mr. Attorney General, how intimately involved was the Department in helping to frame the proposal sent to the Congress by the President?

JUSTICE DEPARTMENT'S INVOLVEMENT IN PRESIDENT'S PROPOSAL

Attorney General THORNBURGH. We were solicited and offered our input on the law enforcement portions of the proposal developed by the President.

Senator SARBANES. Were you solicited and did you offer an input on the regulatory and supervisory changes that might be made or did that come primarily from——

Attorney General THORNBURGH. I think that came primarily from the regulatory community, but would reflect the results of our joint deliberations over the last 3 or 4 years.

Senator SARBANES. Well, it seems to me that it might be to everyone's advantage if we got the benefit of the Justice Department's view in a more direct fashion on some of these supervisory and regulatory provisions.

One of the problems here is—at least so it seems—and it's reflected in the divisions that are now being made in the responsibilities—that there's been too much interlocking between the regulators and the advocates of the industry and so forth, and it seems to me if we could get it in short order on the basis of what you draw out of the prosecutions you have been engaged in with respect to the Justice Department people on the nature of the supervisory and regulatory requirements that that might be very helpful.

Would you be able to give the committee something pretty quickly? This really follows a bit along the point that Senator Gramm was just making.

Attorney General THORNBURGH. Just three things, Senator.

First of all, through the ongoing activities of the bank fraud interagency working group there is constant interchange between the regulatory and law enforcement communities and a sharing of insights and observations on ways to improve the overall structure.

Second, the details of this proposal, the total proposal, are still being worked out. The Treasury has the lead role, but we are interacting with them on a daily basis to flesh out the program that you will ultimately have to consider.

But so saying, we would obviously be pleased to furnish to the committee whatever useful observations we might have in the regulatory area and I would undertake to do so.

Senator SARBANES. Mr. Chairman, I think it would be helpful if we might bring back the Department or get at least a communication which would reflect the perspective of those who come in after the fact to bring enforcement about how regulation and supervision might have been different and made enforcement unnecessary.

Attorney General THORNBURGH. That's a byproduct that we hope to get from all these presentations and to the extent that we have that we will be glad to share it with the committee.

Senator SARBANES. What is the view of the Department about how appropriate, in terms of severity, the penalties being imposed by the courts in these cases are?

Attorney General THORNBURGH. It's kind of hard to assess at the moment because of the shifting of gears caused by the *Mistretta* case in which the Supreme Court has approved the sentencing guidelines. As the Senator knows, in a great many judicial districts, while those guidelines were in effect, pending the determination as to their constitutionality, sentences in general were not being imposed under the guidelines and it makes it difficult to assess how effective the guideline provisions are and we are currently reviewing the sentencing guidelines in cases of this sort as part of the President's overall initiative.

Senator SARBANES. Do the guidelines include fines as well as prison terms?

Attorney General THORNBURGH. Yes.

Senator SARBANES. Because I must say to you, on page 6 of your testimony, reporting on the criminal charges from the activities of the Dallas task force—then I looked at the appendix Mr. Dennis has to his statement, and as you read through it, first of all, fines totaling $133,000 and 20 convictions, most of the imprisonments—there's been no imprisonment. It's 150 hours of community service or 300 hours of community service and so forth. I don't necessarily want to push that side of it as hard as I do this notion of recovering the ill-gotten gains, not just restitution but also fines. I gather there's some provision where you can get a double fine. But it's not quite clear to me why the economic consequences of these activities are not significantly greater than they are in these instances in which convictions have been obtained, let alone this problem that you are now having to deal with of obtaining additional convictions.

Does the Department have a view on that? Are you walking out of these things shaking your head and saying there should have been a heavier fine, there should have been a stiffer penalty here, someone should have actually served some time in jail?

Attorney General THORNBURGH. I can't address particular cases because I don't know the details of them. But I want to repeat the observation I made earlier about the impact of the sentencing guidelines in this area. Those guidelines have had up until the *Mistretta* case a somewhat checkered career because they were not uniformly applied. There were hundreds of courts that declared them unconstitutional and didn't apply them.

We now have a clear framework for sentencing white collar crime, including the offenses involved in these cases under the sentencing guidelines. We are examining those guidelines as part of the overall review of the savings and loan area to determine just what the Senator suggests—that is, whether the guidelines which impose responsibilities on the courts to mete out sentences only within parameters permissible within the guidelines are sufficiently tough.

When we complete that review we will share the results of that with you. But in these cases—again, without knowing the particulars—I can't give you a rundown, but I would say clearly operating under the guidelines, whether they are in present form or in toughened form as I suggest, is far preferable to the type of helter-skelter sentencing we were getting before.

Senator SARBANES. What is your perception of the cooperation or activity on the part of State enforcement? A lot of these abuses occurred in State-chartered S&L's who had Federal insurance and they were allowed to engage in a range of activities which permitted many of these dealings to take place. In the law enforcement area, what is going on on the State side and what is the perception of the Department of Justice in that regard?

Attorney General **Thornburgh**. Well, I think the perception of the Department in these types of cases is clearly that with rare exceptions in some of the major metropolitan prosecutors' offices, these types of cases are really beyond the ability of State and local enforcement activities to deal with. They are highly sophisticated cases involving a lengthy paper trail often disguised by very skillful crooked business people, and it is for that reason that we accept a special responsibility within the U.S. Department of Justice for dealing with these cases.

By the same token, however, my experience as a prosecutor has always been that State and local prosecutors are more than willing to cooperate, supplement, complement, and otherwise aid ongoing Federal prosecutions, and I know of no instance where that has been a hindrance to effective prosecution other than the fact that most State and local prosecutors simply don't have the resources, the expertise, or the priority because of their involvement as their number one priority in dealing with crime and violence in the community.

Senator **Sarbanes**. Thank you.

The **Chairman**. Thank you. Let me just indicate before calling on Senator Pressler that we have three Senators who are left a question, and then, we have two additional witnesses to hear from today who have some very significant testimony to present to the committee. I want to say to Mr. Attorney General, you have been very patient and forthcoming today. We appreciate it, but I wanted the members and others here to be aware of the fact that when the Attorney General finishes two other witnesses are bringing very important information to the committee.

With that, Senator Pressler.

Senator **Pressler**. Thank you very much, Mr. Chairman.

Thank you, Mr. Attorney General, for being so vigorous in heading up this effort to collect from the savings and loans. Many of the subjects have been covered, but one practical matter is how do you spend the $50 million that you have been allocated? I know you probably beef up your staffs and spend money here and there, but will you be hiring new lawyers and can you hire lawyers that are experienced enough and competent to go against the white collar type of the people who will be hired by the white collar criminals? We have been hearing about Government pay and so forth. When you get down to a matter of administration, how are you going to spend that $50 million in terms of will you hire a lot of new lawyers on a 2-year basis or what will you do?

HOW TO SPEND THE ADDITIONAL FUNDS

Attorney General **Thornburgh**. The exact particulars of the proposal are still being worked on, Senator, but I think it's fair to say that the majority of the new hires will be special agents of the Federal Bureau of Investigation, particularly those who have accounting and financial backgrounds that are suited to these types of investigations.

There will be additional assistant U.S. attorneys included in the program and additional attorneys in the fraud section of the Criminal Division of the Department of Justice, and additional tax lawyers to aid in that aspect of this investigation.

It is clear that across the board Federal law enforcement operates at an increasing disadvantage with regard to pay scales, for it's not the quantity of the addition to our work force of investigators and prosecutors that's as important as the quality of those who we can attract into Federal service. When I was last with the Department of Justice in the Ford administration, across the board, prosecutors and investigators were the elite of law enforcement within the Department of Justice and other law enforcement agencies.

Upon returning to the Department last year, there had been almost a 180-degree turn in that standing relative to our State and local counterparts. That's not all bad because State and local law enforcement agencies are gearing up with much more effective operations of their own. But the fact of the matter is that we must seek to hire assistant U.S. attorneys in the District of Columbia today at between $23,000 and $27,000 a year when they can go to a Wall Street law firm in New York and make $75,000 a year or almost three times that.

The relative standing of FBI and DEA agents and Bureau of Prisons personnel with regard to State and local counterparts has drastically declined in recent years. Now there is, as you know, a congressionally mandated study that is being undertaken with regard to these relative pay standards, but I must say that it's my determination to be a zealous advocate for making our Federal law enforcement agencies more competitive so that we can maintain the quality that's necessary to pursue the types of cases that are involved in white collar crime.

These are not cases that you make by banging down the door and putting the cuffs on. They involve an often protracted and always sophisticated paper chase that requires particular skills that we face the prospect of not being able to attract in years to come if we don't make these adjustments in the pay structure.

So the Senator's concern is well placed and I expect that we will have some specific recommendations in that regard.

Senator PRESSLER. Let me ask you this. What about the States? Are they helping you out, the State law enforcement agencies? Are they going to increase their expenditures in States where there have been more of the fraud?

I come from a State that has had almost no fraud, I might say with some pride, or I hope no fraud, that I know of, and there is some feeling that the small banks and small S&L's who have followed the conservative practices are paying for the sins of the big rollers down in Texas and elsewhere. Are some of those States going to kick in and help out?

Attorney General THORNBURGH. It's difficult for States to handle these kinds of cases in the normal instances except in the larger metropolitan areas where that degree of sophistication is developed. And States have as their prime concern dealing with violent crimes and the kind of street crime that the Federal Government doesn't normally get involved in.

But as I indicated earlier, there are instances where States can be helpful and cooperative and I know of no instance where they have been asked for assistance and haven't been forthcoming.

Senator **Pressler**. Thank you very much, Mr. Chairman.

The **Chairman**. Thank you very much, Senator Pressler.

Senator Bryan.

Senator **Bryan**. Mr. Chairman, I'm anxious to hear the following witnesses. I will yield my questions at this point.

The **Chairman**. Senator Shelby.

Senator **Shelby**. Mr. Chairman, I'll try to be brief since I was the last one here.

Mr. Attorney General, I want to publicly congratulate you on what you've done at the Justice Department since you've been there. I believe you've brought back basic confidence and integrity to the Justice Department and I believe you will continue in that role.

Two observations. One, could you furnish for the committee—and this Senator and I believe Senator Bond and also Senator Sarbanes have delved into this—the details of these sentences of what really transpired one-by-one and the circumstances that's been talked about from the task force in Dallas? Will you do that?

Attorney General **Thornburgh**. Certainly.

Senator **Shelby**. The other observation I have, you said—and I certainly agree with this—on page 2 of your opening statement:

> My experience as a U.S. attorney and Assistant Attorney General and as Attorney General teaches that the best way to deter fraud is with tough, timely, and effective law enforcement.

Has the law enforcement dealing with the fraud in the thrift industry been as timely as it could have been? I know you haven't been over at the Justice Department. You were Governor of Pennsylvania way back there. But this fraud has been creeping out and then gushing out of the savings and loan industry not just last year but several years back. Do you have any comments on that?

Attorney General **Thornburgh**. Well, I think so far as the timeliness is concerned from the point of view of law enforcement, it has been a function of the shortage of resources. There are many dedicated——

Senator **Shelby**. A shortage of people?

Attorney General **Thornburgh** [continuing]. Expert prosecutors out there who have been working very hard to handle these cases, but we are delighted I must admit by the recognition from both the President and from this committee and your colleagues of the fact that this is not an effort that can be undertaken without a substantial commitment of resources. So any problems of timeliness I think can be ameliorated by swift action on this proposal.

Senator **Shelby**. And timeliness will mean nothing without the right people either?

Attorney General **Thornburgh**. That's right.

Senator **Shelby**. There's going to be a lot of money or has been a good bit of money recovered by FSLIC in the civil actions against the various people who have been perpetrating fraud on FSLIC and ultimately on the taxpayers since we're going to have to do a lot of that.

Do you have any judgment at this time whether or not the Justice Department Civil Division under your direction should take over these cases since you're going to be dealing in what we think is going to be millions and millions of dollars?

Attorney General THORNBURGH. I think that certainly the Civil Division with its experience and expertise in this area could do a credible job in this area, yes.

Senator SHELBY. Would that be something for the President of the United States and the Treasury and you together to consider?

Attorney General THORNBURGH. That is part of the fine tuning of the President's proposal that is going forward, yes.

Senator SHELBY. OK. I would like to hear from you on this some more too.

Attorney General THORNBURGH. All right.

Senator SHELBY. Mr. Chairman, thank you.

Senator SARBANES. Thank you very much. Senator Bond, do you have anything further?

Senator BOND. No, sir. I am interested in hearing the next witness as well. I certainly appreciate the extra effort that the Attorney General and Mr. Dennis have provided in getting us this information.

Senator SARBANES. Very good. Mr. Attorney General, before we let you leave, I just want to follow up on one thing that Senator Shelby had to say, and that is that I want to underscore the support that exists here for the effort you are making more broadly with respect to restoring high standards and a very deep sense of integrity in the Department of Justice. I can't think of any department where it is more important that the American people have a sense of confidence and trust in its activities, and we certainly urge you on in that task. We very much appreciate your coming this morning and being with us, and we look forward to you supplying us the additional information that was requested and working very closely with you as we proceed to frame this legislation. Thank you very much.

Attorney General THORNBURGH. Thank you, Mr. Chairman.

Mr. DENNIS. Mr. Chairman, I request that my statement be made a part of the record this morning.

Senator SARBANES. It certainly will, Mr. Dennis, and we appreciate your being here with the Attorney General.

Mr. DENNIS. Thank you.

[The complete statement of Mr. Dennis follows:]

STATEMENT

OF

EDWARD S.G. DENNIS, JR.
ASSISTANT ATTORNEY GENERAL
CRIMINAL DIVISION

BEFORE

THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

CONCERNING

FRAUD AGAINST SAVINGS AND LOAN ASSOCIATIONS

ON

FEBRUARY 9, 1989

Mr. Chairman and Members of the Committee,

I am pleased to be here today to address the questions presented in your letter of January 24, 1989. The Department of Justice welcomes the Committee's continuing interest in the area of fraud against financial institutions.

Let me begin by responding to the Committee's invitation to provide information and recommendations which we believe are relevant to preventing future problems in the savings and loan industry. I want to emphasize that our main role in this area is to enforce federal criminal laws designed to protect federally insured financial institutions, and the federal supervisory agencies which oversee them, from fraud. We have placed a high priority on investigating and prosecuting financial institution fraud and other white-collar crimes. In the area of fraud against financial institutions, the Department's policy, published in the United States Attorneys' Manual since 1985, is as follows:

> U.S. Attorneys shall place bank fraud and bank bribery prosecutions high on their list of white collar crime enforcement priorities. The health of the nation's banking industry is essential to the health of the nation's economy. Instances of bank bribery and bank fraud, even if directed toward relatively small banks, seriously undermine the confidence and trust the individuals and businesses place in the banking industry as a whole. That confidence and trust will diminish all the more if the public fails to perceive a comprehensive and active federal law enforcement presence in the industry.

United States Attorneys' Manual 9-40.539A.(November 5, 1985)

INTERAGENCY COOPERATION

It is of the utmost importance that Federal criminal law enforcement officials and officials from the financial institution supervisory agencies engage in regular consultation. In this regard, the Interagency Bank Fraud Enforcement Working Group (Working Group) was created in December 1984, to address problems and promote cooperation toward the goal of improving the Federal Government's response to white-collar crime in the nation's federally regulated financial institutions. The Working Group is composed of officials from the Fraud Section of the Criminal Division, the Federal Bureau of Investigation (FBI), Federal Home Loan Bank Board (FHLBB), Federal Deposit Insurance

Corporation (FDIC), Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (FRS),

National Credit Union Administration (NCUA), Farm Credit Administration (FCA), and the United States Attorney for the District of Delaware representing the Attorney General's Advisory Committee of United States Attorneys. The Working Group's accomplishments include:

> IMPROVED COORDINATION AND COMMUNICATION BETWEEN THE DEPARTMENT OF JUSTICE AND THE BANKING AGENCIES AT BOTH THE HEADQUARTERS AND FIELD LEVELS;
>
> ESTABLISHMENT OF THE SIGNIFICANT REFERRAL TRACKING SYSTEM, A SYSTEM MAINTAINED BY THE FRAUD SECTION WHICH RECORDS MATTERS IDENTIFIED BY THE BANK AGENCIES AS SIGNIFICANT;
>
> PROMOTING RECENT AMENDMENTS TO THE RIGHT TO FINANCIAL PRIVACY ACT (CONTAINED IN THE ANTI-DRUG ABUSE ACT OF 1988); AND
>
> ENCOURAGING THE CREATION OF LOCAL BANK FRAUD WORKING GROUPS TO STRENGTHEN ENFORCEMENT EFFORTS AT THE LOCAL LEVEL.

Local bank fraud working groups have been formed in at least sixteen districts. (See Attachment A). These working groups are representative of cooperative efforts, involving federal (and in some instances state) regulators, criminal investigators, and prosecutors; such cooperative efforts, we believe, are essential to most effectively and efficiently deal with fraud against financial institutions

Now let me address the numbered questions listed in your letter.

(1) How many insolvent or problem S&L's has the Justice Department examined?

The Executive Office for United States Attorneys collects and maintains statistics about the prosecutive activity of the United States Attorneys; the Fraud Section, as a service to the financial institution supervisory agencies, collects and maintains information about criminal referrals which the supervisory agencies have selected for tracking. Neither system contains statistics directly responsive to the Committee's question; however, the Executive Office for United States Attorneys, at the request of the Criminal Division, has asked each United States Attorneys Office to compile and send to the Department information for our use in preparing a full response to the Committee's question. We have asked the United States Attorneys to include information for the period 1982 through 1988.

In addition, the FBI has reported that as of February 1988, there were 357 failed financial institutions (banks and savings and loan associations) under FBI investigation. In 1987 there were 282 and in 1986 there were 206.

(2) In how many of these insolvent or problem institutions have you discovered fraud?

The FBI becomes involved in investigations involving banks and savings and loan associations upon receipt of allegations of criminal activity, or suspected criminal activity, which are obtained from various sources, including referrals from the victim financial institutions, the supervisory agencies, informant information, public source information, other independent law enforcement agencies, and independent FBI investigation. Hence, the very nature of this process results in the discovery of fraud in a substantial number of the referrals.

(3) How many cases has the Justice Department brought and how many matters are still under investigation?

Requests for this information were included in the Department's inquiry to the United States Attorneys, and we will promptly supply the Committee with the results of our inquiry after we have them. For the Committee's immediate use, an overview of financial institution prosecutions in which the Fraud Section of the Criminal Division played a substantial role in the period 1988 through January 31, 1989, is attached (See ATTACHMENT B).

According to FBI statistics, 7,385 bank fraud and embezzlement cases were pending the end of September 1988. 3,446 of those cases involved losses estimated to exceed $100,000.

(4) Does the Department contemplate initiating numerous additional investigations in this area?

We do contemplate initiating numerous additional investigations. This is because numerous financial institutions which are having financial problems will no doubt be scrutinized by examiners and auditors. Civil suits might ensue. In our experience, such scrutiny and civil litigation very often surface allegations leading to a criminal referral to the Department of Justice. In addition, we anticipate allocating substantial additional investigative and prosecutive resources to this area as soon as such resources become available. This increased effort will produce additional investigations.

(5) What are the most prevalent types of fraudulent activity you have found in the institutions you have investigated? (please illustrate through case examples)

The cases listed in ATTACHMENT B are typical. The types of criminal conduct involved in fraud against savings and loan associations are varied. They include practices such as:

Nominee Loans - Loans obtained by one person on behalf of an undisclosed person. The nominee or "straw borrower" typically has no involvement in the loan transaction other than to pose as the borrower.

Double Pledging of Collateral - Loans obtained at two or more different financial institutions by pledging the same property as collateral. The combined amount of the loans exceeds the value of the property and the borrower does not disclose the pledging of the property as collateral to a previous loan.

Reciprocal Loan Arrangements - Loans made to insiders of a financial institution or sold to the financial institution itself based upon an agreement with insiders of another financial institution to reciprocate in future loan transactions. This arrangement results in less than arms-length transactions between insiders of the two financial institutions and has been used previously to conceal loans from financial institution examiners.

Land Flip - Transfers of land between related parties to fraudulently inflate the value of the land. The land is used as collateral for loans based on the inflated or fraudulent valuation. Loan amounts typically greatly exceed the actual value of the land.

Linked Financing - The practice of depositing money of one financial institution into another financial institution with the understanding that the financial institution receiving the deposit will make a loan to an official of the depositor conditioned upon receipt of the deposit.

Embezzlement - This is one of the most common offenses. This crime at one end of the spectrum: may involve a teller who "borrows" $100 from his or her cash drawer for some personal use while at the other end of the spectrum it may involve the president of a financial institution who embezzles millions through manipulation of the institution's records.

Check Kiting - Check kiting usually involves several checking accounts at several financial institutions. The customer writes checks on one account causing a potential overdraft in that account; however, prior to the overdraft occurring, the customer deposits checks from another account, which is being potentially overdrawn, into the first account. This switching of funds back and forth can create artificial balances and some of the artificial funds are skimmed off by the customer for personal use.

False Statements - The use of false financial statements, false appraisals, and other false information in connection with making a loan application is a common offense. Likewise, fraudulent schemes often involve the falsification of records of a financial institution to facilitate the scheme.

(6) In cases in which the Justice Department has found fraudulent activity was this due to failure to adequately supervise by the relevant regulator of the failing or problem institutions?

Some have claimed that lax or inadequate supervision by federal and State supervisory agencies contributed to the existing savings and loan problem. In addition, inexperience of many examiners adversely affected the ability of regulators to exercise fully their supervisory authority. While these two factors, shortages and inexperience of examiners, provided an increased opportunity for those who would victimize a financial institution to do so, we cannot say that fraudulent activity was due to such deficiencies.

What is clear is that, in a number of the larger savings and loan associations that eventually became insolvent, the controlling shareholders, who also served as directors or senior management in their institutions, deliberately engaged in course of conduct -- including criminal violations, regulatory violations, and highly imprudent lending and investment practices -- that directly imperiled the safety and soundness of the institutions to which they owned a fiduciary duty. In a word, greed is the principal cause of the fraudulent activity we have found.

(7) In cases where the Justice Department has found fraud can you estimate the dollar amount and what proportion, if any, can be recovered?

We know of no statistically reliable way in which we can calculate the precise dollar amount of fraud associated with a particular financial institution, at least until a Federal grand jury has returned an indictment or an individual has entered into a plea agreement with the Government. The reason is that in many of our investigations, law enforcement agents and prosecutors spend very substantial portions of time scrutinizing all aspects

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of specific transactions that may involve fraudulent activity. Many transactions may be the direct result of blatant mismanagement, such as repeated lending to unqualified or marginal borrowers, but may not be characterizable as fraud if additional factors such as the use of false and misleading statements were not present. Once a Federal grand jury has determined that there is probable cause to believe that a particular person has committed specified Federal crimes relating to such transactions, or an individual has pleaded guilty to specified Federal crimes, prosecutors have a clearer understanding of the scope of the fraudulent activity and can more readily quantify it.

Typically, following the conviction of an offender, the prosecutor will seek an order from the sentencing Federal district judge directing the defendant to make restitution to victims who have suffered a financial loss as a result of the offense. The Government bears the burden of proving the amount of the loss by a preponderance of the evidence. The court, in determining whether to order full restitution, must consider the financial resources of the defendant, the financial needs and earning ability of the defendant and the defendant's dependents, and such other factors as the court deems appropriate. To the extent that the court determines that the complication and prolongation of the sentencing process resulting from the fashioning if an order of restitution outweighs the need to provide restitution to any victims, the court may decline to make such an order.

Although restitution orders are routinely sought pursuant to the provisions of the Victim and Witness Protection Act in cases where restitution is feasible, the defendant's lack of financial resources often will preclude obtaining restitution for the victim financial institution or its Federal insurer.

(8) What changes in the regulatory system of supervising S&L's would the Justice Department recommend?

As you know, and as the Attorney General has noted, on February 6, President Bush announced a major and comprehensive initiative to restore the federal deposit insurance system to full health. One point in the President's initiative is a substantial overhaul of the existing regulatory mechanisms to limit unnecessary-taking. I understand that the details of the President's plan are to be presented to Congress shortly.

The importance of making timely referrals to criminal law enforcement authorities of information indicating that a crime has been committed cannot be overemphasized. In order to ensure such timeliness, the Working Group developed a standard referral form designed to elicit from federally insured financial institutions the type of information deemed most important to the

FBI and the United States Attorney in initially assessing the prosecutive merit of a suspected violation. Supervisory agencies established requirements that referrals be made and encouraged continuous communications at the local level between regulators investigators, and prosecutors to facilitate early referrals. These, and other efforts akin to them, have vastly improved the referral process, but more timely referrals remains a goal which we would like to see achieved.

(9) What changes to enforcement laws and procedures would make it easier for regulatory and criminal enforcement authorities to discover, quickly stop, and successfully prosecute fraudulent behavior in the savings and loan industry?

It is important to note that current law includes numerous criminal statutes addressing virtually every kind of conduct likely to be involved in a bank fraud case and that vigorous enforcement of existing law is what is needed most to deter bank fraud. Indeed, the main bank fraud statute, Section 1344 of Title 18, United States Code, is one of the most comprehensive statutes found in the Federal Criminal Code. In addition, current penalty provisions are formidable; for offenses occurring after December 31, 1984, individuals convicted of a felony may be fined the greatest of (1) the amount specified in the law defining the offense, (2) $250,000 or (3) twice the gross pecuniary gain or twice the gross pecuniary loss resulting from the offense (whichever is greater).

Despite the existence of strong criminal provisions, improvements which would strengthen enforcement efforts should be made and are included in the President's initiative. Civil and criminal penalties for violations of regulations and criminal statutes would be increased. In particular, the President's plan would increase maximum civil penalties from $1,000 per day to $1 million per day, and would increase maximum criminal penalties to twenty years imprisonment. Forfeiture provisions designed to recover the proceeds of illegal activity could be added. Proposed legislation containing such provisions will be submitted by the Administration to this Congress.

In addition, the United States Sentencing Commission's sentencing guidelines could be toughened. The existing guidelines for offenses involving fraud, which are published as Section 2F1.1 of the United States Sentencing Commission's Guidelines Manual, are in my opinion too lenient. For a bank fraud violation resulting in a $25,000,000 loss to the victim financial institution, for example, the culprit could receive a mere 30 months' imprisonment, perhaps even less.

LOCAL BANK FRAUD WORKING GROUPS

DISTRICTS

Central District of Illinois (Springfield)
Northern District of Illinois (Chicago)
Central District of California (Los Angeles)
Eastern District of North Carolina (Raleigh)
Southern District of Texas (Houston)
Western District of Washington (Seattle)
Southern District of Georgia (Savannah)
Southern District of Indiana (Indianapolis)
Northern District of Florida (Tallahassee)
Western District of Wisconsin (Madison)
District of Utah (Salt Lake City)
Eastern District of New York (Brooklyn)
Southern District of Florida (Miami)
Eastern District of Missouri (St. Louis)
Northern District of Texas (Dallas)
District of New Mexico (Albuquerque)

ATTACHMENT A

DALLAS BANK FRAUD TASK FORCE PROSECUTIONS

1. Background

In August 1987, the Federal Bureau of Investigation launched THRIFTCON, an operation designed to facilitate identifying and prosecuting the most culpable perpetrators of Federal crimes directed against savings and loan associations ("thrifts") and banks doing business in the Northern District of Texas. The United States Attorney for the Northern District of Texas and the Special Agent in Charge of the Dallas Division of the FBI asked that the Fraud Section provide prosecutorial supervision and trial attorneys for a task force created to carry out THRIFTCON. The Fraud Section responded to this request with a substantial commitment of Section resources. In November 1987, one senior trial attorney was stationed on-site in Dallas to coordinate task force efforts. Several additional Section trial attorneys were assigned to spend all or a substantial part of their time on THRIFTCON.

By the beginning of 1988, the task force, which had become known as the Dallas Bank Fraud Task Force, consisted of nine Fraud Section attorneys spending all or most of their time on THRIFTCON, a Special Assistant United States Attorney supplied by the Federal Home Loan Bank Board, three Assistant United States Attorneys, one Tax Division attorney (part-time), one squad of twenty Special Agents of the FBI, and several agents from the Internal Revenue Service. In addition to providing an on-site senior trial attorney-coordinator and eight trial attorneys to THRIFTCON, the Fraud Section assigned one Deputy Section Chief to oversee the prosecutorial activities of the task force. At the end of 1988, the FBI's allocation of investigators had increased by two Special Agents with three to five additional Special Agents to be assigned to the task force early in 1989. The IRS contingent had grown substantially to a group of fifteen agents and a Group Manager. The Fraud Section's contingent, in addition to its senior trial attorney in Dallas, consisted of five trial attorneys (full-time) and two trial attorneys (substantial part of their time). Two other Section attorneys provided support for the task force in 1988 on an ad hoc basis.

2. Task Force Accomplishments through January 31, 1989

a. Overview

The task force has filed sixteen criminal informations, each charging a single defendant, pursuant to plea agreements

ATTACHMENT B

negotiated in 1988, by task force attorneys. Ten of the defendants pleaded guilty in 1988, and seven were sentenced. Three defendants have pleaded guilty in 1989.

The task force has brought ten indictments charging a total of seventeen defendants. Two of the indictments, one charging three defendants and the other charging one defendant, were returned in the fall of 1987, and two of these defendants were sentenced in 1988. A third defendant committed suicide following his conviction. The fourth defendant indicted in 1987, was tried, convicted by a jury, and sentenced in 1988. All three of the defendants have taken appeals from their convictions.

Six of the indictments, charging a total of eight defendants, were returned in 1988. Two of these indictments, each involving a single defendant, were resolved prior to trial through guilty pleas to felony charges. These defendants were sentenced in 1988. One indictment was tried before a jury and the sole defendant was convicted. His sentencing was scheduled for early in 1989. The fourth indictment resulted in the jury acquittal of the sole defendant. The two remaining indictments are scheduled for trial early in 1989. One involves three defendants and the other charges a single defendant.

Two indictments have been returned in 1989. One involves three defendants. The other involves two defendants.

In summary, the task force has brought criminal charges against thirty-three individuals. Four of these individuals were charged in the fall of 1987, twenty-one of them were charged in 1988, and eight have been charged this year. Twenty convictions have been obtained. Three of these occurred in 1987, fourteen occurred in 1988, and there have been three convictions this year. Twelve of the convicted individuals have been sentenced. All of the sentencings occurred in 1988. Four of these individuals were sentenced to probation, but eight of them received terms of imprisonment. These terms ranged from a low of six months to a high of thirty-five years. Fines totaling $133,250.00 were imposed and restitution totaling $2,791,500.00 was ordered ($591,500.00 of the restitution was directed to the Federal Savings and Loan Insurance Corporation).

A chronological list of the task force prosecutions initiated by the filing of an information will be provided immediately below. This list will be followed by a list of the task force prosecutions initiated by the return of an indictment.

Informations

(1) United States v. Larry K. Thompson

A one-count information, charging aiding the willful misapplication of the funds of an institution whose accounts were insured by the Federal Savings and Loan Insurance Corporation ("FSLIC") (18 U.S.C. §§ 657, 2), was filed February 1, 1988, against Larry K. Thompson, formerly a real estate broker doing business with now failed State Savings and Loan Association ("State") in Lubbock, Texas. Mr. Thompson had aided the payment of a $100,000.00 kickback to Tyrell G. Barker, the majority shareholder and Chairman of the board of directors of State. Mr. Thompson pleaded guilty February 23, 1988, to this charge and to a one-count information filed in the Central District of California charging that he had concealed his knowledge of the commission of a felony involving a scheme to defraud victims seeking loans (18 U.S.C. § 4). Mr. Thompson entered his pleas in the Northern District of Texas pursuant to Rule 20 of the Federal Rules of Criminal Procedure ("Fed.R.Crim.P."). He was sentenced June 2, 1988, on the section 657 charge to three years' probation, 150 hours of community service, and a $2,000.00 fine. For the section 4 offense he was sentenced to three years' probation, to run concurrently with the probation imposed for the section 657 offense, an additional 150 hours of community service, and an additional fine of $250.00.

(2) United States v. Tyrell G. Barker

A one-count information, charging willful misapplication of the funds of an institution whose accounts were insured by FSLIC (18 U.S.C. § 657), was filed February 8, 1988, against Tyrell G. Barker, formerly the majority shareholder and chairman of the board of directors of State. Mr. Barker pleaded guilty February 12, 1988, and was sentenced March 25, 1988, to five years' imprisonment, with all but six months suspended, and five years' probation. In addition, he was ordered not to affiliate with any financial institution, to perform 100 hours of community service annually during the probationary term, to make restitution of $100,000.00 to FSLIC, and to pay a $50.00 special assessment. This sentence was to be consecutive to the term of imprisonment Mr. Barker was serving in another case.

(3) United States v. Sam Thomas III

A two-count information was filed February 8, 1988, against Sam Thomas III, formerly the chief executive officer and chairman of the board of now failed Commerce Bank ("Commerce") in Plano, Texas. One count charged that Mr. Thomas filed a false document with the Federal Reserve Bank of Dallas misrepresenting the financial condition of Commerce (18 U.S.C. § 1001). The other count charged that Mr. Thomas caused an unauthorized letter of credit to be used as collateral for a loan at the since failed Northwest Bank in Dallas, Texas.

(4) United States v. John G. Smith

A one-count information was filed February 8, 1988, against John G. Smith, formerly a senior executive vice-president of Vernon Savings and Loan Association ("Vernon"). The information charged Mr. Smith with causing a Quarterly Financial Report of Vernon containing a false statement to be filed with the Federal Home Bank Board ("FHLBB") (18 U.S.C. § 1001). Mr. Smith pleaded guilty February 25, 1988, and was sentenced October 13, 1988, to five years' imprisonment, but execution of this sentence was suspended and he was placed on five years' probation. In addition, he was sentenced to 500 hours of community service, restitution of $330,000.00 to FSLIC, and a bar from employment by any bank or thrift.

(5) United States v. John V. Hill

A one-count information was filed March 24, 1988, against John V. Hill, formerly a senior vice-president of Vernon, charging him with conspiracy (18 U.S.C. § 371) to violate the bank bribery statute (18 U.S.C. § 215), to make false entries in the books and records of Vernon (18 U.S.C. § 1006), and to defraud the United States, in particular the FHLBB, the Federal Election Commission, and the Internal Revenue Service. Mr. Hill pleaded guilty April 7, 1988, and was sentenced June 16, 1988, to five years' imprisonment, with the execution of all but six months suspended, five years' probation, 600 hours of community service, and to pay $11,500.00 restitution to FSLIC.

(6) United States v. Herman K. Beebe, Jr.

On April 29, 1988, two related single-count information were filed in connection with offenses committed in the Northern District of Texas and the Western District of Louisiana, respectively, by Herman K. Beebe, Sr., a Louisiana businessman doing business with State. The informations respectively charged Mr. Beebe with assisting with the submission of a false draw request on a loan made by State, which transferred the funds by wire to the account of Bossier Bank and Trust Company in Louisiana (18 U.S.C. § 1343) and with conspiracy (18 U.S.C. § 371) to file false statements to influence the action of a Louisiana bank on a loan application. Mr. Beebe pleaded guilty to both informations April 29, 1988, and was sentenced the same day to concurrent sentences of imprisonment for one year and one day.

(7) United States v. Ronald D. Campbell

A two-count information was filed May 26, 1988, against Ronald D. Campbell, formerly a real estate developer, builder, and borrower from State. The two counts each charged Campbell with making a false statement to State to obtain two loans (18 U.S.C. § 1014). Previously, on May 6, 1988, Mr. Campbell had pleaded guilty to one count of making a false statement to State Savings Bank of Corvallis, Oregon. The Texas case was transferred from the Northern District of Texas to the District of Oregon pursuant to Fed.R.Crim.P. 20, and Mr. Campbell was sentenced on both informations August 29, 1988. In the Texas case, on count one, Mr. Campbell received five years' probation to be served after completion of his sentence of imprisonment imposed in the Oregon case, 240 hours of community service, a $5,000.00 fine and a $50.00 special assessment. On count two he received five years' probation to run concurrent to count one, an additional fine of $5,000.00, and a $50.00 special assessment. In the Oregon case, Mr. Campbell was sentenced to two years' imprisonment, a $5,000.00 fine, and to pay $150,000.00 restitution to FSLIC.

(8) United States v. Terry Loper

A one-count information was filed June 16, 1988, against Terry Loper, an accountant for a Houston-based company formerly doing business with now failed Sunbelt Savings Association ("Sunbelt"), charging him with conspiracy (18 U.S.C. § 371) to violate 18 U.S.C. § 1344 by defrauding Sunbelt by obtaining loan proceeds from Sunbelt through the use of false and fraudulent invoices. Mr. Loper pleaded guilty December 1, 1988.

(9) United States v. Roy F. Dickey, Jr.

A one-count information was filed June 30, 1988, against Roy F. Dickey, Jr., formerly an executive vice-president of Vernon, charging him with making a false statement to influence the action of FSLIC (18 U.S.C. § 1008). Mr. Dickey pleaded guilty August 4, 1988, and was sentenced September 8, 1988, to two years' imprisonment. Execution of the sentence was suspended and he was placed on five years' probation, including 500 hours of community service and alcoholism treatment.

(10) United States v. Jack D. Franks

A one-count information was filed September 1, 1988, against Jack D. Franks, a Dallas real estate consultant formerly associated with Vernon, charging him with aiding another individual connected with Vernon with illegally receiving money through a Vernon transaction (18 U.S.C. §§ 1006, 2). Mr. Franks has agreed to plead guilty to this charge and to plead guilty to one count of bank fraud (18 U.S.C. § 1344) in United States v. Olsvik, a case indicted in the District of Oregon May 25, 1988. The Olsvik indictment charges Mr. Franks and others with defrauding State Federal Savings and Loan Association in Corvallis, Oregon.

(11) United States v. Barry S. Gillingwater

A one-count information was filed September 30, 1988, against Barry S. Gillingwater, a businessman who once was a major borrower at Sentry Savings Association ("Sentry") in Lubbock, Texas, charging Mr. Gillingwater with conspiracy (18 U.S.C. § 371) to violate 18 U.S.C. § 1344 (bank fraud) and to make false material statements to influence Sentry to make loans (18 U.S.C. § 1014).

(12) United States v. Richard Randall

A two-count information was filed November 22, 1988, against Richard Randall, a businessman who once was a borrower at First State Bank of Rockwall ("FSBR"), Rockwall, Texas, charging him with causing false statements to be made to FSBR by a nominee seeking a loan on Mr. Randall's behalf. Mr. Randall pleaded guilty December 16, 1988.

(13) United States v. Richard Boone

A one-count information was filed November 29, 1988, against Richard B. Boone, once a borrower from Northwest Bank ("NWB") in Dallas, Texas, charging him with submitting a false financial statement to NWB in connection with a $670,000.00 loan (18 U.S.C. § 1014).

(14) United States v. Joseph Daniel Hudgins

A two-count information was filed January 24, 1989, against Joseph Daniel Hudgins, a certified public accountant and a director and treasurer of Drill Equip., Inc., charging him with conspiracy (18 U.S.C. § 371) to defraud Western State Bank of Denton, Texas, and federal regulators, in connection with a scheme to fund a gold mine project, and making false statements to Western State Bank (18 U.S.C. § 1014). Mr. Hudgins pleaded guilty to these charges on January 24, 1989.

(15) United States v. William Melvin

A one-count information was filed January 24, 1989, against William Melvin, vice president of Drill Equip., Inc., charging him with falsely stating to Western State Bank that a loan he was seeking would be secured with accounts receivable which be owned (18 U.S.C. § 1014). Mr. Melvin pleaded guilty on January 24, 1989.

(16) United States v. Marvin W. Wallen

A one-count information was filed January 24, 1989, against Marvin W. Wallen, a mechanic and engineer employed by Drill Equip., Inc., charging him with aiding and abetting a misdemeanor violation of 18 U.S.C. § 656 (misapplication of bank funds). Mr. Wallen had applied for a loan from Western State Bank and had falsely listed that the loan would be secured by a piece of machinery. He pleaded guilty on January 24, 1989.

D. Indictments

(1) United States v. Robert W. Gunter et al.

On July 23, 1987, a multiple-count indictment, charging conspiracy (18 U.S.C. § 371), bank fraud (18 U.S.C. § 1344), and false statements to an institution whose accounts were insured by the Federal government (18 U.S.C. § 1014), was returned against Robert W. Gunter (president of Best Motors, Inc. and Roadshow, Inc. in Dallas, Texas), Bobbie Jean Gunter (Robert's mother and corporate secretary, title clerk, and bookkeeper), and Virginia A. Thomas (Robert's sister and representative of Robert's businesses in banking transactions). The task force tried this case at the request of the United States Attorney and obtained guilty verdicts against all the defendants November 9, 1987, following a jury trial. Robert Gunter committed suicide December 30, 1987. His mother and sister each were sentenced to five years' imprisonment. In addition, they were ordered to make restitution of $2,200,000.00 to the victim financial institutions. The defendants have appealed their convictions.

(2) United States v. H. Wailen York

On September 15, 1987, a multiple-count indictment was returned against H. Wailen York, a Dallas area contractor formerly doing business with now failed Empire Savings and Loan Association ("Empire"), charging him with wire fraud (18 U.S.C. § 1343), making false statements to a Federal agency (18 U.S.C. § 1001), and making false statements in connection with loan applications (18 U.S.C. § 1014). While this case resulted from a separate operation in the Northern District of Texas, "TEXCON," the task force tried the case in the spring 1988, at the request of the United States Attorney. The task force obtained verdicts of guilty against Mr. York April 12, 1988, following a jury trial. Mr. York was sentenced May 25, 1988, to thirty-five years' imprisonment, five years' probation, and a $108,000.00 fine.

Mr. York's convictions related to a scheme to defraud Empire Savings & Loan Association of Mesquite, Texas; Bell Savings Association of Belton, Texas; Lancaster Federal Savings & Loan Association of Lancaster, Texas; First State Building & Loan Association, Mt. Home, Arkansas; and Mercantile Bank, Garland, Texas. Between 1981 and 1984, Mr. York obtained more than 20 loans totaling in excess of $30 million by submitting five different fraudulent financial statements to the federally insured institutions. At trial it was shown that the financial statements inflated Mr. York's assets and omitted substantial liabilities. These loans were mostly intended for land acquisitions and condominium construction along the I-30 corridor east of Dallas, Texas. At the time, Mr. York was also the principal builder of projects with comprise the subject matter of a separate indictment against seven other defendants (United States v. David L. Faulkner, et al.). Mr. York has appealed his conviction.

(3) United States v. Donald W. Nahrwold

On February 8, 1988, a three-count indictment was returned against Donald W. Nahrwold, a real estate broker and business associate of Tyrell G. Barker, majority shareholder and chairman of the board of directors of now failed State. The indictment charged Mr. Nahrwold with conspiracy (18 U.S.C. § 371), aiding with the misapplication of the funds of an institution whose deposits were insured by FSLIC (18 U.S.C. §§ 657,2), and making false statements to a Federal agency (18 U.S.C. § 1001). Prior to trial, Mr. Nahrwold agreed to plead guilty to aiding with a kickback to Tyrell G. Barker of $100,000.00 from a $2,000,000.00

loan made by State to Larry K. Thompson (18 U.S.C. §§ 657,2). He entered his plea March 10, 1988, and was sentenced June 2, 1988, to three years' probation and a $3,000.00 fine.

(4) United States v. Thomas Merrill Gaubert

On March 15, 1988, a five-count indictment was returned in the Southern District of Iowa, charging Thomas Merrill Gaubert, a Dallas, Texas financier and real estate developer associated with Independent American Savings Association in Texas and now failed Capitol Savings and Loan Association ("Capitol") in Mt. Pleasant, Iowa, with wire fraud (18 U.S.C. § 1343), making false statements to Capitol (18 U.S.C. § 1014), and making false statements in a matter within the jurisdiction of a Federal agency (18 U.S.C. § 1001). Task force attorneys participated in this case at the request of the United States Attorney for the Southern District of Iowa. Two task force attorneys and an Assistant United States Attorney from the Southern District of Iowa tried the case in Iowa from October 6, 1988, until its submission to the jury October 27, 1988. The jury acquitted Mr. Gaubert October 29, 1988.

(5) United States v. Gordon Glenn Melcher

On June 15, 1988, an eight-count indictment was returned against Gordon Glenn Melcher, formerly a director and loan committee member of now failed Irving Savings Association ("Irving"), charging him with wire fraud (18 U.S.C. § 1343), causing the entry of a false material statement in Irving's books and records (18 U.S.C. § 1006), and obstruction of justice (18 U.S.C. § 1503). Prior to trial, Mr. Melcher agreed to plead guilty to a wire fraud charge contained in the indictment and to a one-count felony information, filed September 28, 1988, charging him with causing a false statement to be made in Irving's records for the purpose of deceiving Irving officials and others (18 U.S.C. § 1014). Mr. Melcher pleaded guilty October 3, 1988, and was sentenced December 14, 1988, on the wire fraud count to five years' imprisonment, with execution of all but six months suspended, five years' probation, 2,000 hours of community service and a $1,000 fine. He was sentenced on the section 1014 charge to five years' probation and a $5,000 fine.

(6) United States v. Wayne Barnhart

On September 19, 1988, a one-count indictment was returned against Wayne Barnhart, a resident of and businessman from Waco, Texas, charging him with lying to a Federal grand jury by falsely denying having any recollection that he had told two Special Agents of the FBI, individually and on three separate occasions, that an FSLIC employee once told him that he should "get dumb" before the grand jury. The trial in this case began December 5, 1988, and ended December 7, 1988, with a jury verdict of guilty.

(7) United States v. Bennett Lowell Rosenthal, et al.

On October 12, 1988, a twelve-count indictment was returned against Bennett Lowell Rosenthal (a Houston real estate developer and borrower from Sunbelt Savings Association) ("Sunbelt"), Ralph Eugene Strader (a business associate of Mr. Rosenthal), and Mary Jane Wilson (office manager for Messrs. Rosenthal and Strader). The indictment contains charges of conspiracy (18 U.S.C. § 371), false statements to a Federal agency (18 U.S.C. § 1001), false statements to an institution whose deposits are insured by the Federal government (18 U.S.C. § 1014), bank fraud (18 U.S.C. § 1344), and entering a financial institution with the intent to commit a felony (18 U.S.C. § 2113(a)). The gist of the charges is that the defendants conspired to create and submit false invoices and other documents in connection with draw requests relating to a loan initially funded by Sunbelt Service Corporation for MT-I, Ltd., a real estate and development company with which the defendants were affiliated. Jury selection began February 6, 1989.

(8) United States v. Woody F. Lemons

On November 13, 1988, a thirteen-count indictment was returned against Woody F. Lemons, formerly the chairman of the board of directors of now failed Vernon, charging him with bank fraud (18 U.S.C. § 1344), misapplication of Vernon funds (18 U.S.C. § 657), conspiracy (18 U.S.C. § 371), illegally sharing in the proceeds of a thrift transaction (18 U.S.C. § 1006), and bank bribery (18 U.S.C. § 215).

The indictment charges that Mr. Lemons defrauded Vernon by arranging an inflated loan for the purchase and development of property in Arlington, Texas, and receiving a sharo of the loan proceeds from an intermediate seller of the property. The loan was inflated by $3.5 million ostensibly for the purpose of having the intermediate seller buy either from Vernon or from Vernon borrowers properties in actual or imminent foreclosure. According to the indictment, however, Mr. Lemons planned to use one half of the $3.5 million for his own personal benefit. In fact, because of funding problems at Vernon, only about $200,000 was eventually transferred to Mr. Lemons.

The indictment also alleges that Mr. Lemons conspired to defraud the United States, specifically examiners of the Federal Home Loan Bank Board, by concealing his receipt of the loan proceeds through the use of an intermediary and bogus consulting fees.

The indictment further alleges that Mr. Lemons received a $9,000 check from a loan broker in connection with a sale of Vernon loans and passed the check with a forged endorsement. Trial is scheduled to begin April 3, 1989.

(9) United States v. Robert H. Hopkins, Jr., E. Morten Hopkins, and John W. Harrell

On January 12, 1989, a Federal grand jury in the Northern District of Texas (Dallas) returned a forty-seven count indictment naming three Dallas residents as defendants. The indictment charges all three defendants, Robert H. Hopkins, Jr. (age 57), his brother E. Morten Hopkins (age 49), and John W. Harrell (age 54), with conspiracy (18 U.S.C. § 371) to (1) defraud the United States, in particular the Federal Election Commission (FEC), Federal Home Loan Bank Board (FHLBB), and Federal Savings and Loan Insurance Corporation (FSLIC), of its right to have its affairs conducted free from deceit, dishonesty, unlawful impairment, and obstruction, and (2) commit offenses against the United States; namely, to conceal and cover up a material fact in a matter within the FEC's jurisdiction (18 U.S.C. § 1001), to misapply funds of Commodore Savings Association (Commodore) (18 U.S.C. § 657), and to make false entries in the records of Commodore (18 U.S.C. § 1006). Commodore was a financial institution having accounts insured by the FSLIC. As a result of a recent merger, Commodore has been renamed Consolidated Federal Bank, FSB.

According to the indictment, in the period June 1983 to October 1985, Robert Hopkins was a principal shareholder and Chairman of the Board of Directors of Commodore, John Harrell served as Vice-Chairman of the Board and Chief Executive Officer of Commodore, then later became Chairman, and Morten Hopkins succeeded John Harrell as Vice-Chairman of the Board of Commodore.

In addition to the conspiracy count, Robert Hopkins and Morten Hopkins each are charged with two counts of causing material facts to be concealed from the FEC (18 U.S.C. § 1001). Finally, all three defendants are charged together with twenty-two counts of causing funds of Commodore to be misapplied

(18 U.S.C. § 657) and with twenty-two counts of causing false entries to be made in Commodore's records (18 U.S.C. § 1006).

The indictment charges that the defendants participated in a conspiracy involving the concealment from the FEC, FHLBB, and FSLIC of corporate financial contributions made in support of, or in opposition to, various individuals seeking federal, state, and local elective office. The indictment alleges that employees of various corporations in which Robert H. Hopkins was a principal shareholder (National Mortgage Corporation of America, Big Country Savings, and Commodore) were used as conduits for these corporate financial contributions, that Commodore funds were illegally employed for such contributions, and that false entries were made in the books and records of Commodore to deceive the FHLBB and to injure and defraud Commodore.

(10) United States v. Patrick W. Emmott and William A. Baggett

On January 27, 1989, a forty-four count indictment was returned in the Eastern District of Texas charging Partick W. Emmott, formerly the president and a director of Western State Bank, and William A. Baggett, president of Drill Equip., Inc., with conspiracy to defraud the United States, in particular the Federal Deposit Insurance Corporation (FDIC), of its right to have its affairs conducted free from deceit, dishonesty, unlawful impairment, and obstruction (18 U.S.C. § 371). The two defendants were also charged with conspiracy to commit offenses against the United States; namely, making a false, material statement in a matter within the FDIC's jurisdiction, making a false, material statement with intent to influence Western State Bank, making false entries in the books and records of Western State Bank, transporting money obtained by fraud across state lines and conducting a scheme to defraud Western State Bank. Western State Bank of Denton, Texas, was a financial institution having accounts insured by the FDIC. Western State Bank was closed by federal regulators in September 1985, and has reopened as Texas Bank of Denton.

In addition to conspiracy, the two defendants were charged with seven counts of making false statements to Western State Bank (18 U.S.C. § 1014), ten counts of making false statements in a matter within the jurisdiction of the FDIC (18 U.S.C. § 1001), two counts of causing false entries to be made in Western State Bank's records (18 U.S.C. § 1005), four counts of bank fraud 18 U.S.C. § 1344), twelve counts of mail fraud (18 U.S.C. § 1341) and eight counts of interstate transportation of money obtained by fraud (18 U.S.C. § 2314).

The indictment alleges that Mr. Emmott and Mr. Baggett conspired to defraud Western State Bank and the FDIC by arranging a series of loans for borrowers, totalling over $2.5 million, and then using the loan proceeds to fund a gold mine development project in Liberia, Africa. Allegedly, the loans were supposedly for the purchase of excavation equipment, but in most cases the equipment was not purchased and the proceeds were wire transferred to Liberia to fund the gold mine project. Allegedly, the loans were obtained by falsifying the borrowers' financial statements and various loan documents to create the impression that the borrowers were creditworthy and were the true recipients of the loan proceeds.

OTHER RECENT BANK FRAUD PROSECUTIONS IN WHICH THE FRAUD SECTION HAS PLAYED A SUBSTANTIAL ROLE

1. United States v. David Lamar Faulkner et al. Northern District of Texas

On October 7, 1987, an 88 count indictment was returned, charging seven defendants with conspiracy (18 U.S.C. § 371), and charging individual defendants and combinations of defendants with RICO conspiracy (18 U.S.C. § 1962(d), wire fraud (18 U.S.C. § 1343), interstate transportation of stolen property (18 U.S.C. § 2314), misapplication of savings and loan funds (18 U.S.C. § 1006), and willfully overvaluing land used as security (18 U.S.C. § 1014). The indictment charges the defendants with a conspiracy to divert more than $100 million in loan proceeds from federally insured savings and loan associates for their personal benefit through a scheme involving hundreds of millions of dollars in fraudulent loans made by four Texas savings and loan institutions and one Arkansas thrift.

Named as defendants are major Dallas real estate promoters David Lamar Faulkner, James Larkin Toler, and their business associate, Kenneth Earl Cansler. Also charged are Spencer Hayward Blain, Jr., formerly chairman of the board of directors of now failed Empire Savings and Loan Association, Mesquite, Texas, and Paul Arlin Jensen, who had been associated with both Lancaster First Federal Savings and Loan, Lancaster, Texas, and Bell Savings Association, Belton, Texas. Two land appraisers, Arthur Formann and Paul Douglas Tannehill, also are named as defendants.

The indictment resulted from a four-year investigation by the FBI, the Texas Department of Public Safety, and the United States Attorney for the Northern District of Texas. At the request of the United States Attorney, two Fraud Section Attorneys participated in the development and preparation of the charges alleged in the indictment. One Section attorney was assigned full-time to this case throughout 1988, and is a member of the trial team. Jury selection began February 6, 1989.

B. United States v. William R. Runnells, Jr. et al. Eastern District of Virginia

At the request of the United States Attorney for the Eastern District of Virginia, the Fraud Section provided one Section trial attorney in 1988 to augment the prosecution team assigned to investigate fraudulent sales by Landbank Equity Corporation ("Landbank") of second mortgage loans. The efforts of the prosecution team resulted in the return of a 73 count indictment April 21, 1988, naming five defendants. Two of the defendants, William R. Runnells, Jr. (a founder of Landbank), and Marika Runnells (formerly the president and chief executive officer of Landbank), have been fugitives since April 1988. Another defendant, Ross E. Schumann, Jr. (formerly a senior vice-president of Landbank) committed suicide September 18, 1988, the day before opening statements were scheduled to begin in the trial of the case.

The trial began September 14, 1988, with jury selection. The two remaining defendants, Frank E. Butler III, attorney for Landbank and close associate of Mr. Runnells, and Owen R. Thornton, Landbank's accountant, each were convicted November 28, 1988, following a two month jury trial. The jury found Mr. Thornton guilty on 26 counts of wire fraud (18 U.S.C. § 1343), one count of violating the Racketeer Influenced and Corrupt Organizations Statute (RICO) (18 U.S.C. § 1962(c)), one count of conspiracy to violate RICO (18 U.S.C. § 1962(d)), and one count of making a false statement to a federally insured institution (18 U.S.C. § 1014). The jury acquitted Mr. Thornton on one count of wire fraud and could not reach a verdict on nine wire fraud counts and one bankruptcy fraud count (18 U.S.C. § 152).

The jury found Mr. Butler guilty on 35 counts of wire fraud, nine counts of bankruptcy fraud, one count of violating RICO, one count of conspiracy to violate RICO and three counts of making false statements to a federally insured institution. The jury could not reach a verdict on one count of wire fraud.

On January 6, 1989, Mr. Thornton was sentenced to six years' imprisonment and ordered to pay $10,000 restitution. Mr. Butler was sentenced to eight years' imprisonment and ordered to pay $100,000 restitution.

Mr. Butler and Mr. Runnells formed Landbank in 1980 in Virginia Beach, Virginia, principally to originate and sell mortgage-backed loans. On September 17, 1985, Landbank went bankrupt. By that time, Landbank had sold over 10,000 mortgage loans to approximately 40 investor institutions all over the country, including the Federal National Mortgage Association and federally insured savings and loan associations. The loans sold totalled approximately $200 million. At its height, Landbank operated over 30 offices in five states.

The convicted defendants defrauded the investor institutions by misrepresenting Landbank's financial strength and the quality of the loans it sold to investors. They falsified information contained in mortgage loan applications, overstated the creditworthiness of borrowers and the value of the property that secured the mortgage loans, and understated the delinquency rates on the loans.

3. United States v. Thomas Taro, Sr. District of Columbia

At the request of the United States Attorney for the District of Columbia, the Fraud Section assumed responsibility for an investigation, which had been pending in the United States Attorneys Office, involving National Permanent Federal Savings and Loan Association ("National Permanent") and Thomas Taro, Jr., owner of Taro construction company. One Section attorney was assigned to this investigation throughout 1988.

National Permanent, which had its principal office in the District of Columbia, was closed in 1986 by the Federal Savings and Loan Insurance Corporation ("FSLIC"). It was merged with Citicorp after an infusion of funds by FSLIC.

In April 1981, Taro and his construction company entered into a joint venture agreement with Permanent Financial Corporation ("PFC"), a wholly-owned subsidiary of National Permanent, to develop a commercial office building in Silver Spring, Maryland. National Permanent financed the project through a system of reimbursements based on draw requests and invoices.

A one-count information was filed against Mr. Taro, charging him with making a false statement to National Permanent for the purpose of influencing an extension of credit (18 U.S.C. § 1014). He pleaded guilty on September 20, 1988, and was sentenced November 18, 1988, to a suspended sentence of two years' imprisonment, five years' probation, 150 hours of community service during each of the first three years of probation, and a $5,000.00 fine.

4. United States v. Don C. Davis, et al.
District of Wyoming

At the request of the United States Attorney for the District of Wyoming, one Fraud Section trial attorney was assigned beginning in January 1988, to work with an Assistant United States Attorney from the District of Wyoming on an important bank fraud case indicted in the district November 10, 1987. This case required virtually all of the Section attorney's time in 1988.

The original indictment was superseded by a twenty-one count indictment returned August 18, 1988. Three defendants were charged. Defendant Don C. Davis was a commercial banker and an owner of Evco, Inc., which owned First National Bank in Evanston. He was also a director of Stockgrowers State Bank and was an owner, president, and chairman of the board of directors of Stockgrowers State Bank Company, Inc., which owned Stockgrowers State Bank. He was also an owner of Guaranty Federal Bank, was a consultant to the bank, and acted as its agent. Additionally, he was a director of Wyoming Financial Services Center Corporation ("WFS"), and was a signatory on its bank account.

Defendant David M. Burke was a partner in the Wyoming law firm of Burke and Brown, P.C. He was an owner of Evco, Inc. and was a member of its board of directors. He was also a member of the board of directors of Stockgrowers State Bank Company, Inc. He was an owner of Guaranty Federal Bank and was a member of its board of directors. He was an officer of WFS and was a signatory on its bank account.

Defendant John A. Edmiston was an owner and president of Evco, Inc. He was an owner and member of the board of directors of Stockgrowers State Bank Company, Inc.

The superseding indictment charged the defendants with conspiracy (18 U.S.C. § 371), wire fraud (18 U.S.C. § 1343), misapplication of the funds of an institution whose accounts were insured by the FSLIC (18 U.S.C. § 657), false entries in the books and records of an institution whose accounts were federally insured and illegally participating in loans made by such an institution (18 U.S.C. § 1006), false statements to a Federal agency (18 U.S.C.§ 1001), and false statements and overvaluing security to influence a Federally insured institution to make a loan (18 U.S.C. § 1014). The gist of the charges was that the defendants had acquired control of a financial institution through deceit and guile involving misrepresentation to the Federal Reserve Board, then illegally diverted funds from the institution for their own use.

The trial of this case began October 11, 1988. John A. Edmiston pleaded guilty on the eve of trial to one felony count of making a false entry in bank records. The charges against the other two defendants were submitted to the Jury December 16, 1988. On January 10, 1989, the jury returned guilty verdicts against both defendants.

The jury found Mr. Davis guilty of conspiracy, five counts of wire fraud, four counts of misapplication of federally insured funds, three counts of false entries in bank records, and one count of making a false statement to a bank in connection with a loan. Mr. Davis was acquitted on the remaining six charges against him.

The jury found Mr. Burke guilty of conspiracy, three counts of wire fraud, four counts of misapplication and three counts of false entries in bank records. Mr. Burke was acquitted on the remaining seven counts.

5. United States v. Gregory J. Harsch et al.
District of Oregon

Two Fraud Section attorneys spent a substantial amount of their time in 1988, working on United States v. Gregory J. Harsch et al., a case being handled by the Fraud Section at the request of the United States Attorney for the District of Oregon. This case began with the return of a seventeen-count indictment February 10, 1988, charging Gregory J. Harsch and Jerry L. Burke in connection with the February 1984 collapse of Emerald Empire Banking Company ("Emerald Empire") of Eugene and Springfield, Oregon. Mr. Harsch is a former real estate developer and contractor who was a major borrower from Emerald Empire. Mr. Burke was formerly the president of Emerald Empire.

The indictment charges both defendants with conspiracy to defraud Emerald Empire, the regulators, and the Federal Reserve Board (18 U.S.C. § 371), four counts of misapplication of bank funds through use of nominees to make loans with the proceeds actually passing to Mr. Harsch (18 U.S.C. § 656), four counts of making false entries in the records of the bank by identifying the nominee borrower as the true debtor to the bank (18 U.S.C. § 1005), and four counts of filing false certificate of completion statements with the bank for the purpose of releasing funds from construction loans made for the benefit of Mr. Harsch (18 U.S.C. § 1014). Mr. Burke is also charged with one count of submitting a false statement to the Federal Reserve Board (18 U.S.C. § 1001). Mr. Harsch is also charged with two counts of submitting false financial statements to the bank in which he concealed and omitted over $950,000 in liabilities (18 U.S.C. § 1014), and one count of perjury in a deposition in a civil suit filed by the Federal Deposit Insurance Corporation (18 U.S.C. § 1623).

The CHAIRMAN. Let me just say as you are leaving the room, Mr. Attorney General, to add my words of appreciation to those of the other members—I had to step out for a moment—but we appreciate your time and the directness of your answers today.

Attorney General THORNBURGH. Thank you.

The CHAIRMAN. We look forward to working with you.

Let me call our next witnesses to the table. Mr. Joe Selby, who is the former Chief Regulator of the Federal Home Bank of Dallas and who is now bank consultant for Insignia Co. in Dallas, TX, and Mr. David W. Gleeson, who is president, Lincoln Asset Management Co., Dallas, TX.

If they would come forward at this time, and if we can get the name tags changed.

As people are entering and leaving the room, let me indicate and restate what I said earlier, and that is, that we have very important testimony to hear from these two witnesses. Sometimes the testimony comes early in the morning, sometimes it comes at the lunch hour, but I want to indicate that the committee views the testimony we are about to receive as very important testimony. I appreciate the presence of our witnesses, and if everyone can find a seat, we will begin.

Mr. Selby, we would like to hear from you first.

STATEMENT OF H. JOE SELBY, FORMER CHIEF REGULATOR, FEDERAL HOME LOAN BANK OF DALLAS, BANK CONSULTANT, INSIGNIA CO., DALLAS, TX

Mr. SELBY. Thank you, Mr. Chairman, and members of the committee.

I appreciate being invited to appear before you. I have submitted written testimony which I would like to be put in the record, if I might. What I will do now is briefly summarize my discussion of fraud and the state of the industry in Texas and the Southwest, as I found it when I arrived. I have to say that President Bush somewhat preempted some of my comments and recommendations, and I applaud his efforts and this committee's efforts in doing some things about a situation I was heavily involved in for 2 years. I think the time is right, if not past, and I applaud your efforts in doing something about it.

I start this discussion in reiterating what I put in my written testimony that as a regulator, a former regulator, I speak as a regulator, and when you talk about fraud, regulators generally include a wide discussion of fraud besides that of the statutory definition, that of willful misconduct, et cetera, that carries the criminal sanctions.

WILLFUL MISCONDUCT

We consider equally as serious the abuse of financial institutions by flagrant self-dealing and conflicts of interest, which ultimately impact the financial institution, its investors and the insurance fund. Equally as serious is the mismanagement of a financial institution which generally is a result of the violations of what we call safety and soundness standards in individual institutions as well as the industry as a whole.

All of these types of fraud and abuse occurred in great number in the Southwest in the thrift industry. That is, in Texas, but also in Louisiana and Arkansas and, to some extent, New Mexico.

My experience over the years as a banking regulator and in 2 years as a thrift regulator showed me and was reaffirmed that generally most management of financial institutions during a period of a good economy look good, including poor management. It is generally the good management that when the economy goes sour has planned for cyclical downturns in the economy, and they generally survive. The poor management don't plan, and therefore, seldom survive. I think that is an important distinction that we look at, and it goes to the accountability of management to direct their financial institutions. I think you take this and you add the opportunities that were available in the Southwest thrift industry through the deregulation of the savings and loans. As Senator Garn brought out, the particularly extensive deregulation of some of the States, particularly Texas, in direct investments in real estate projects beyond the permissible activities of Federal institutions.

The CHAIRMAN. Let me just ask you at that point, and I don't want to interrupt too often the flow of your testimony but I want to nail down some of the points as we go, so you are asserting that you feel that the broader powers granted by some States that had a higher risk profile are a material part of this problem; is that right?

Mr. SELBY. There is no question about it. I think the Federal Home Loan Bank Board at the time under the chairmanship of Ed Gray clearly saw the direct investment regulation promulgated by Texas and, I think, by California, were contributing to it, and, as you know, he overrode State law with the direct investment limitations at the Bank Board. So, yes, I would say that some of the institutions, some of them that have been mentioned today in Texas had very large direct investments that contributed to their problems.

The CHAIRMAN. All right. Please proceed.

Mr. SELBY. In addition to the opportunities, you had an outdated regulatory structure that had been established both at the Federal and the State levels, again, a regulatory structure at the Federal level that was attuned to an industry that was making single-family mortgage lending, and all of a sudden, they were in commercial and the other types.

You also had an economy in the Southwest that was overheated, overheated, indeed, by unrestrained lending that some of the financial institutions were doing and certainly a limited ability to bring in money through brokered deposits, et cetera.

Finally, in my opinion and others in the Southwest, you did have a limited talent of managers in the thrift industry.

I think all of these factors attracted what we call so- called entrepreneurs. I don't want to put an onerous burden on the true entrepreneurs, but so-called entrepreneurs are owners, managers of these thrift institutions that were interested in making quick profits. They had made very small investments probably in purchasing these financial institutions. In fact, some of them had made no investment, because they gave notes for the purchase, and eventually they didn't pay the notes to the farmer shareholders. I think a lot of them crossed the line, in my opinion, between what I call questionable practices and flagrant self-dealing or even fraud.

When the problems were eventually discovered, I don't think there was any doubt in anyone's mind that they were massive. Certainly there wasn't in our mind as we were finding insolvencies and examples of fraud and self-dealing in the large volume. About the same time I went to Texas, Chairman Gray had already begun to do some things to curtail the activities. He had issued the growth regulations, the capital regulation, the direct investment regulation and the asset classification regulation. He also, as you, I am sure, know, wanted legislation in various forms, and unfortunately, I think at that time his voice was somewhat alone in the wilderness of wanting enforcement powers and some things that he thought were needed in the Bank Board system.

The CHAIRMAN. I might just say at that point, Mr. Selby, that you may recall that he was seeking more regulatory and supervisory personnel. At the time, we were trapped, we were told by OMB, by the Gramm-Rudman-Hollings restrictions that prevented that. We had a major fight over the issue to break the agency out of that straitjacket to get the help. And there is a very pointed record on the Senate floor to that effect. We finally succeeded because, of course, these agencies are funded by the fees from the industry, and clearly, the notion of not providing the money need for an adequate supervisory force was unjustified. It was just wrong.

But in any event, why don't you proceed?

Mr. SELBY. I guess one of the advantages of Chairman Gray was, he could do it through the Banks, the Federal Home Loan Bank System, whereas some of the other Federal agencies could not do it, the banking regulators, for example. And I agree, that was in my testimony, the constraints that were placed on him in trying to respond to these effects of the entrepreneurs and not having the quality or quantity of examiners and the pay of people that had to do this job.

Once these problems began being discovered, I have to say—what I have said is that the entrepreneurs realized the tap on the faucet was about to be shut off by the regulators in Texas, not surprisingly so. Back in that time of my life and my supervisory staff in Dallas, the pressures were tremendous on the process of supervision, as we were trying to discover the problems, stop the mismanagement, the fraud and get people out and get new management in. There were considerable delays in our actions because of the pressures and because of things put on us to, you know, slow the process down. I love the papers at the time and the accusations that were being leveled were, you know, we were to blame for the industry going broke, which I thought was rather laughable, and also it can't be as bad as the regulators say it is, which I think has come back to say that it was as bad as we were saying it.

I think the ultimate hold was the FSLIC recapitalization. Certainly, it wasn't enough. It was probably too late. It certainly hindered our efforts in trying to close these institutions, as we found their insolvencies. The holding patterns, in my opinion, did nothing but hold them. It cost FSLIC lots of money in operating them in that holding pattern, added to the bottom line of red ink that

FSLIC or the taxpayers or the Government is going to have to recognize.

I don't want to go back into all of my testimony, as I said, but I do think——

The **Chairman**. Let me make this suggestion to you.

Mr. **Selby**. Surely.

The **Chairman**. I think that history is a valuable one, and I think we've heard elements of that from others as well. I think an area where you can be particularly helpful to us is to go directly at the fraud issue: How widespread is it, what caused it to happen, what is there out there for us to find. You heard the Attorney General. You probably are in as good a position to lay the fraud issue out as anybody, and I would like you to do that now, if you would.

Mr. **Selby**. You know, I have to, again, in talking about 2 years at the Federal Home Loan Bank of Dallas and seeing the cases I saw—remember, I was seeing the worst of the worst, and in trying to equate an estimate of how much was fraud and how much was mismanagement, I define "mismanagement" as accountability, and all I can tell you is, the majority of the cases I was involved in was fraud and/or mismanagement and/or abuses through self-dealing and conflicts of interest. It seemed every day we were looking at cases that involved those types of things.

I think the causes of it, I have stated it became easy for entrepreneurs to come in, and they found their own piggy bank. Unfortunately, they forgot or they didn't care to recognize that they weren't dealing with their money, they were dealing with insured deposits, and the avenue was open because of a lack of regulatory structure that had been addressed by the very same things you said, adequate people, adequate powers, the ability to take prompt action. I think, too, in my opinion, when I came to Texas, there had already been several well-publicized failures—the Empire, the Mainland, Mercury—some of those that had been well-publicized. At the State level, some of the MCP institutions that had been under control of the Federal Home Loan Bank for up to 2 years, more than 2 years. And there had not been very much prosecution of criminal activities in the thrift industry nor guilty verdicts on a lot of people.

The **Chairman**. Why was that?

Mr. **Selby**. I really can't answer that.

The **Chairman**. Were you asking for that?

Mr. **Selby**. We desperately wanted some signal by getting some of the guilty parties thrown into jail, that this is what is going to happen, we want to deter fraud in the financial sector and particularly——

The **Chairman**. Did you go to the U.S. attorney?

Mr. **Selby**. What I did, as I said, I found that there were two problems, one that, indeed, not very much was being done, and quite frankly, I think some of the questions were asked at the State level, as one of the members asked a while ago, what was being done by the State authorities. And I believe I was told by the State Commissioner of S&L's that he would refer things to the State Attorney General, and basically, would not followup on it. We were also in a similar situation at the Federal Home Loan Bank of Dallas. We would make the criminal referrals on the forms and in the form that was prescribed. Unfortunately, we found that the U.S. attorney and the FBI needed much more assistance from us. I think the Attorney General indicated they were sophisticated cases. They were very complex. Our examiners—for example, there was one very large institution that we were trying to get a hold on and examining, a multibillion dollar institution. It took months and months for us to examine it. It took us—after we completed the exam, we took the examiners back in there just to draft the criminal referrals. And as I recall, that took 2 or 3 months just for our examiners to document and draft the criminal referrals.

The **Chairman**. Now did you ask for additional help from above?

ADDITIONAL SUPERVISORS AND EXAMINERS

Mr. **Selby**. When I arrived in Dallas in 1986, we were already, through Chairman Gray, doubling our structure of supervisors and examiners. I think while I was there it went from somewhere around 200 up to in excess of 400. We had over half the staff of the Federal Home Loan Bank of Dallas, where it was very small to begin with. At the end of 1986, then, when all of the industry in Texas began to realize that it was going down here, profitwise, solvencywise—remember the Federal Home Loan Banks are governed by a board of directors who are made up of a majority of the industry in that district. The members of the industry in district 9 were putting considerable pressure on the then President of the Federal Home Loan Bank of Dallas to stop spending so much money. Unfortunately, the supervisory process was caught into that trap, since we were being paid by the Federal Home Loan Bank of Dallas, and we had to agree for a 1987 budget to do a zero-based budget. We could not add any more people. We could not add any more dollars into what we were doing, with one exception that I got through by the new President of the Bank, and that is, we added four positions to help the U.S. attorney's office in the development of their cases on the criminal referrals that we had referred to them.

Senator **Sarbanes**. If I could, Mr. Selby.

Mr. **Selby**. Please.

Senator **Sarbanes**. Was their pressure not to spend any money directed at inhibiting the supervisor and regulatory effort?

Mr. **Selby**. The pressure was, I don't think necessarily—some of it could have been that. What the stated objection was by the director members of the industry was that the industry was being forced to cut back their budgets and their spending and their financial institutions. They were being hard-hit and didn't have as much money as they used to, and therefore, the Federal Home Loan Bank of Dallas, whom they owned, should also cut back on their budget.

Senator **Sarbanes**. Would you say when you went to Dallas you found a general atmosphere that was free and easy even on the part of those not actually engaged in these practices, so there was this kind of tolerance of these activities going on? I mean, who in that environment was on your side in trying to bring these activities under control?

Mr. **Selby**. Very few. Very few. I think, and I don't want to——

Senator **Sarbanes**. So you were the fellow who was ruining the party?

Mr. **Selby**. I was the guy who was the hammer, as I was told several times. I had the hammer. There were good institutions there that supported my efforts. I don't mean to say that there weren't. But the atmosphere was one of, OK, he's going to shut off the spigot. The industry or the good segment of the industry were worried about the effects of the economy on their operations, and they clearly saw their net worth going down, and so it became an atmosphere of fear, quite frankly. And I guess one segment fueled the fear on the other segment, in my opinion, creating this great atmosphere that we were under, my supervisory staff and examiners and myself. And I don't excuse Roy Green. He was under it too. He was the then president of the bank and the PSA. You know, we were really—and you couldn't pick up the paper without some reference to what the regulators were doing, and we were hurting the borrowers, we were hurting the economy, we were destroying the financial institutions.

The **Chairman**. Let me just say at this point, we have sort of started the practice of interjecting. I began it and Senator Sarbanes and Senator Bond is also here, and I want him to feel free to do as well. Let me say at this point, I think what we are hearing for the first time is from a person who was directly in the regulatory position and saw the problem at point-blank range. He saw it develop and was in the position to have to try to deal with it. You are putting on the record for us today for the first time from that vantage point the anatomy of what happened. You were the person charged with the public responsibility to try to blow the whistle on these practices that you believed were out of bounds and yielding to this mounting set of losses that we are now here to see.

So, it seems to me what you are telling us is a very important part of this hearing record. I have questions I want to ask. I want to just ask one, and then I want to yield to Senator Bond. In your testimony you indicate that one of the problems was in this pattern of improper activity is that people would go out, do these deals, take big front-end fees, run those front-end fees through the income statement of the institution, take the money themselves through high salaries and perks and various other things and, in effect, make off with the money on a bad deal. But by the time it would come to light that the particular investment was a bad investment, they had already, in effect, made off with a very substantial personal gain and converted that to personal use. Whether they used it to buy very fancy homes or cars or what have you, some substantial portion of the money was drained away that we are now being asked to replace and restore, depositors' money, left in that form. Is that a fair summary?

Mr. **Selby**. That is correct. And in many forms—profit sharing or dividends or ski chalets in Beaver Creek, CO, or whatever.

The **Chairman**. So, there was a kind of front-end looting that was going on here. Long before it became obvious that these institutions would fail, these people were not just making bad investments, but they were generating a very substantial personal benefit from this and socking it away in their own bank accounts.

Mr. SELBY. Well, you have to look—I testified before the House Banking Committee in February of 1987, when the FSLIC recap was being considered, and we used some examples at that time. And it was amazing to me, coming—we had seen growth in the banking industry, but we had never seen anything like I saw in the State of Texas and the Southwest—it had already happened when I got there. But you're talking about financial institutions, thrift institutions, savings and loans that were bought, that probably had total assets of $200 million when they were bought, and 3 years later, they were $1 billion, $2 billion, $3 billion. And those institutions were fueled by money coming in from all over the country, and they were being placed into, basically, Texas real estate loans or Texas real estate. And part of it I will let David Gleeson get into the specifics, but I mean, the land flips, of course, are the most common things that are referred to in this explosion that constitutes, I think, fraud or alleged fraud or self-dealing, and you know, every time they turned over, you were adding, you know, $1 million, $3 million or whatever the value was of that real estate, and somebody pocketed that money every time.

The CHAIRMAN. Yes. I want to give Senator Bond an opportunity to ask some questions, and then I want to suspend to hear Mr. Gleeson, so that we've got both sets of testimony on the table and then go back to the questioning.

Senator BOND. Thank you, Mr. Chairman.

Mr. Selby, I read your testimony and found it very compelling. This morning I was on a C-SPAN call-in show, and one of the callers said, in response to some statements, I made, he said, oh, come on now. There can't be more than $1 billion worth of losses caused by criminal and fraudulent activity. And I cited the inferences of your testimony to say that, indeed, it could be significantly larger than that.

Did I misquote you?

Mr. SELBY. I don't think you did. As I said, it is difficult, and I qualified by saying I saw the worst of the worse, but it seemed like that's all I saw. And it is a tremendous amount of money; there's no question about it, and probably most of it will not be recovered.

Senator BOND. In response to Senator Sarbanes' question you admitted that, in fact, you were regarded as the skunk at the garden party in the Texas thrift industry.

For our reform purposes, I think it would be helpful for you to go into what you mentioned in your written testimony about the pressures on the regulators when the system is controlled by the industry it is supposed to regulate.

Would you tell us just a little bit about the kind of pressures that existed there to the extent that you feel comfortable doing so?

PRESSURE ON THE REGULATORS

Mr. SELBY. Well, let me include—besides myself in the pressures, the president of the bank and PSA, Roy Green, who hired me and brought me. And being the skunk in the garden party, quite frankly, I was very proud of that. When I got to Texas, my notoriety far exceeded what I thought my ability was at the time, and I told Roy I thought it has a very good effect, as we were trying to discover the problems, "you know, it's all right for me to have the hammer." I soon found out when the pressure started, it was not a great position to be in, and I had never been in it before. And the pressures took a lot of forms.

There was political pressure brought to bear on my constituents—and I don't mean just necessarily owners, managers of savings and loans—I'm talking about borrowers that owed hundreds of millions of dollars to financial institutions and savings and loan. The borrowers seemed to be fairly adept at either marching through the Dallas bank or going to their Congressmen or whoever to try to complain or entreat them to get us to be more kind to them in our examinations.

The CHAIRMAN. To back off?

Mr. SELBY. To back off, yes. There were some instances of what I considered inappropriate inquiries or directions to defer actions or to not take actions that I think would have maybe saved money had we done it faster, or that were not appropriate. And I never criticized the concern of Congress in what was happening nor the right for Congress to tell us we have to be fair and evenhanded and justified. I agreed with that.

My frustration at the Bank Board quite frankly—and I was an outspoken person in this regard to Roy Green the President, and even to the powers at the Bank Board—what we need to do in this system I think is a little better job of, if we have an inquiry, don't take this enforcement action or don't do this at this financial institution, my solution would be to take the file to the congressional office or to whoever is making the inquiry and say, "Here is the file and here is what we're finding and here is why we are taking the action."

I don't think we did that very well.

Senator BOND. Well, let me heighten probably what's an uncomfortable area of inquiry for you because one of the things again I was asked on that program was didn't Congress stick its hands directly into this process? What is the cure for Congress meddling? Without obviously asking for names and neither of us would be comfortable with that, what kinds of pressure did the Dallas FHLB get from individual Congressmen? What did they do? Second, is there any cure for that kind of interference to which you referred in your written testimony?

Mr. SELBY. Well, as I said, the interference, as you called it, or the requests came in a variety of different types, anywhere from when we were taking charge of an organization we get rid of the management, we also replace the directors. We've had requests to keep the old directors, which we never do, and FDIC and FSLIC as you know certainly don't if they take over and do a receivership.

It was to delay enforcement actions because something was going to happen, something indefinite or something definite. That type of thing.

Senator BOND. Well, you have outlined some requests, but were there instances of pressure beyond requests? I know congressional offices make a lot of requests. They are very important in many instances. Sometimes they are inappropriate. You can "just say no", but did you feel there was anything that went beyond perhaps wrong-headed suggestions?

Mr. SELBY. I think there were some things—very few—most of the requests I will say also came to the Bank Board through Mr. Gray's office, too, and I don't know of an instance in the Dallas bank that I can recall where we did not go ahead and do what we had decided to do at the Dallas bank level.

Now at the Bank Board, Chairman Gray was pretty adamant about not stopping an action when it should be. There was only one case where we did delay something because of a special investigation that they had conducted at the Bank Board level, which in my opinion was not necessary and as it proved out to be it was not necessary, but it delayed it I think up to 2 or 3 months.

Senator BOND. Mr. Chairman——

Mr. SELBY. Let me finish. May I just finish one quick thing? You asked about how it can be helped. Well, I equated in my testimony the difference between the system in the banking regulators and the system in the thrift industry regulators. I think the cause is because of that closeness in the thrift industry and the Federal Home Loan Bank Board that has traditionally been there.

Senator BOND. I think, Mr. Chairman, we are going to be dealing with that and that's why I thought that was very helpful, but we have some very important testimony and I will defer the rest of the questions.

The CHAIRMAN. Very good. Let me just do two follow-up points on this.

As I understand your testimony, you say that you felt pressure. You felt it from some of the big borrowers from some of the S&L's. You felt it from some of the congressional inquiries. I take it from other sources as well.

Were there any other categorical sources of pressure that were aimed your way?

Mr. SELBY. Well, I don't think if there were they were very important.

The CHAIRMAN. But you felt pressured. But if I heard you correctly, you said that in no instance did you yield to the pressure, that there was no decision that was changed as the result of whatever pressure you may have been feeling? Is that correct?

Mr. SELBY. As I recall, we did not yield to any of them.

The CHAIRMAN. Now when that kind of thing happened and you felt that it was perhaps inappropriate or over the line, who do you report that to?

Mr. SELBY. Of inquiries?

The CHAIRMAN. Or pressure. If you feel like you are being pressured on a decision and somebody is trying to intervene, who do you report that to?

REPORT INSTANCES OF INAPPROPRIATE PRESSURE

Mr. SELBY. Well, the responsibility was the principal supervisory agent at the Dallas bank, the president and the principal supervisory agent, who I reported to. He, in turn, reported to the Bank Board.

The CHAIRMAN. Were there a number of instances then when you in fact reported to him and said, "Look, somebody is trying to intervene here and I'm uncomfortable with it and these are the facts"?

Mr. **Selby**. Roy Green was always informed of where the pressures came. Sometimes the pressures came directly to him rather than to me.

The **Chairman**. How many times would you have done that, would you say? A dozen, a half a dozen, 40 or 50 times?

Mr. **Selby**. I would say possibly under a dozen—around a dozen. As I said, they did not always come to me. They came to my staff or came to Roy Green.

The **Chairman**. Do you know whether he in turn reported those to Chairman Gray if he was Chairman at that time?

Mr. **Selby**. I do not know whether he did or not. I do know that when Chairman Gray got them he transmitted them to us.

The **Chairman**. Were you ever told that in a situation like that that you can also pick up the phone and call the U.S. attorney?

Mr. **Selby**. No.

The **Chairman**. That is another course of action. If you think something is going on that you think is improper, we have a justice system precisely for that reason. If anybody crosses that line or if there's any reason to think that they may be crossing that line, another action that can be taken is to pick up the telephone and to call the U.S. attorney.

Senator **Sarbanes**. Mr. Chairman, could I follow up on that point?

The **Chairman**. Please do, and then I think we should go to Mr. Gleeson.

Senator **Sarbanes**. Mr. Selby, if I understood your testimony a little earlier, though, you had some concern because matters that were being referred over to the U.S. attorney for criminal action were not being picked up on. Is that correct? You encounter delay and difficulties there in having those carried through. That was part of this environment in which you found yourself. Is that right?

Mr. **Selby**. No. I think that what my statement was when I came to Texas I found there had been little instances of prosecution on those cases that were already existing when I got there of institutions that had been taken over by FSLIC.

And I know that the Dallas bank and the supervisory staff there were doing little, if anything, to help the U.S. attorney or the FBI in developing the cases that had already happened.

What they were doing is developing criminal referrals on new cases as they were being found and forwarding those to the U.S. attorney's office.

Senator **Sarbanes**. Well, who did you regard as an ally that you could go to in all of this to get some action? Was there anyone around?

Mr. **Selby**. Well, Roy Green was my ally and I think Chairman Gray quite frankly at the Bank Board. The Office of Enforcement in Washington was very helpful to us as we were developing actions. In fact, their staff generally lived at the Dallas bank for at least a year and a half that I was there. They were very helpful.

[The complete prepared statement of Mr. Selby follows:]

EXECUTIVE SUMMARY

OF THE STATEMENT OF

H. JOE SELBY

BEFORE THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

OF THE

UNITED STATES SENATE

WASHINGTON, D. C.

FEBRUARY 9, 1989

I. INTRODUCTION

MR. CHAIRMAN AND DISTINGUISHED MEMBERS OF THE COMMITTEE:

THANK YOU FOR THE INVITATION TO APPEAR BEFORE YOU. I HOPE THAT MY TESTIMONY CAN HELP YOU IN YOUR DELIBERATIONS CONCERNING THE STATE OF THE THRIFT INDUSTRY. I WAS ASKED TO DISCUSS WHAT I FOUND IN TEXAS RELATIVE TO THE ISSUE OF FRAUD IN THE SAVINGS AND LOAN INDUSTRY, THE CAUSES AND, FINALLY, THE SOLUTIONS THAT I MIGHT SUGGEST.

MY BACKGROUND HAS BEEN WITH THE FINANCIAL SERVICES INDUSTRY FOR MOST OF MY LIFE. MY 32-YEAR CAREER WITH THE OFFICE OF THE COMPTROLLER OF THE CURRENCY SPANNED MANY POSITIONS AND RESPONSIBILITIES, BUT ALL DEALT BASICALLY WITH EXAMINATION AND SUPERVISION OF THE NATIONAL BANKING SYSTEM, INCLUDING DEVELOPMENT AND REFINEMENT OF SUPERVISORY TECHNIQUES, UTILIZATION OF COMPUTER TECHNOLOGY, MANAGEMENT OF BANK FAILURES, AND LIAISON WITH FOREIGN BANK SUPERVISORS.

I WAS A SUPERVISOR OF THE THRIFT INDUSTRY IN TEXAS FOR A SHORT 2-YEAR PERIOD. WHAT I FOUND IN DALLAS WAS A FINANCIAL AND A REGULATORY SYSTEM AND SITUATION UNLIKE ANY THAT I HAD EVER ENCOUNTERED.

MY TASK WAS TO USE MY EXTENSIVE SUPERVISORY EXPERIENCE AND KNOWLEDGE TO INSTITUTE ORGANIZATIONAL AND PROCEDURAL CHANGES AT THE FHLB OF DALLAS TO PROVIDE A MORE RESPONSIVE AND EFFECTIVE SUPERVISORY MECHANISM FOR THE FUTURE.

THESE EFFORTS WERE CONSIDERABLY COMPLICATED BY THE MASSIVE EFFORTS UNDERWAY TO INDENTIFY AND ADDRESS PROBLEMS IN ALMOST 500 SAVINGS AND LOAN INSTITUTIONS IN THE FIVE-STATE DISTRICT. THOSE PROBLEMS ENCOMPASSED MASSIVE FRAUD, RAMPANT SELF-DEALING AND ABUSIVE CONFLICTS OF INTEREST, MISMANAGEMENT, AND THE 200 OR MORE THRIFT INSTITUTIONS WHICH WERE ON THE VERGE OF INSOLVENCY, OR ACTUALLY INSOLVENT. THE ECONOMY HAD BEEN FUELED BY THE UNRESTRAINED LENDING OF THE FINANCIAL INSTITUTIONS AND, WHEN THE BUBBLE BURST, RESOLUTIONS OF THE PROBLEMS WERE SEVERELY IMPACTED.

I NOTE MY RESERVATIONS IN THE DISCUSSION OF FRAUD OF IDENTIFYING INDIVIDUALS OR SPECIFIC INSTITUTIONS. ALSO, WHILE FRAUD IS NARROWLY DEFINED BY STATUTE, REGULATORS ALSO CONSIDER FLAGRANT PRACTICES OF SELF DEALING AND DELETERIOUS CONFLICTS OF INTEREST EQUALLY AS SERIOUS. THE MISMANAGEMENT OF A FINANCIAL INSTITUTION THROUGH VIOLATIONS OF THE PRINCIPALS OF SAFETY AND SOUNDNESS RESULTING IN THREATS TO THE INSURANCE FUNDS ARE LIKEWISE SERIOUS. ALL OF THESE ENTER INTO MY DISCUSSION TODAY.

II. EXISTING CONDITIONS

BY MID-1986, A MAJORITY OF THE SOME 500 MEMBER THRIFT INSTITUTIONS IN DISTRICT NINE HAD NOT BEEN EXAMINED FOR UP TO 3 YEARS. IT IS IMPORTANT TO REALIZE THAT DURING THOSE 3 YEARS THE INSTITUTIONS, IN LARGE PART HAD EXPERIENCED RAPID GROWTH: IN ASSETS THROUGH ACQUISITION, DEVELOPMENT AND CONSTRUCTION LOANS AND IN LIABILITIES FUNDED BY BROKERED DEPOSITS. OFTEN, THE "ENTREPRENEURIAL" OWNERS/MANAGERS WERE SYSTEMATICALLY TAKING THE UPFRONT LOAN FEES GENERATED IN THAT GROWTH OUT OF THE INSTITUTIONS IN THE FORM OF LARGE SALARIES, DIVIDENDS AND OTHER FORMS OF REMUNERATION. SUBSEQUENTLY, THE ANALYSIS OF THOSE LOAN PORTFOLIOS DISCLOSED IMPRUDENT UNDERWRITING, SELF DEALING AND FRAUD. FSLIC WAS LEFT WITH THE LOSS.

CHAIRMAN GRAY INITIATED MANY EFFORTS TO CURTAIL THE INAPPROPRIATE ACTIVITIES. REGULATIONS WERE ISSUED THAT ADDRESSED THE RAPID GROWTH, DIRECT INVESTMENTS, CAPITAL AND THE CLASSIFICATION OF ASSETS. HE ALSO BEGAN THE EFFORTS TO EXAMINE APPROXIMATELY 300 MEMBER INSTITUTIONS IN DISTRICT NINE IN THE FIRST HALF OF 1986. THE RESULTS OF THOSE EXAMINATIONS REVEALED A SERIOUS IMPAIRMENT OF THE INDUSTRY, PARTICULARLY IN TEXAS.

MY PRIMARY TASK OF UPDATING THE SUPERVISORY PRACTICES AT THE DALLAS BANK WAS COMPLICATED BY THE DAY-TO-DAY RESPONSIBILITIES OF ADDRESSING PROBLEMS OVERALL. THE STAFF WAS DELUGED WITH DRAFTING AND IMPLEMENTING ENFORCEMENT ACTIONS, THE REMOVAL AND REPLACEMENT OF MANAGEMENT, THE FILING OF CRIMINAL REFERRALS, REQUESTING RECEIVERSHIP OF INSTITUTIONS BY FSLIC, AND APPLICATION OF THE NEW ASSET CLASSIFICATION REGULATION. THE TIME CONSTRAINTS AND THE SUPERVISORY NEEDS OF THE DISTRICT PLACED INORDINATE BURDENS UPON ALL OF THE EXAMINING AND SUPERVISORY STAFF.

BY MARCH 31, 1987, 191 THRIFT INSTITUTIONS IN DISTRICT NINE HAD BEEN IDENTIFIED AS COMPRISING THE GREATEST RISK TO FSLIC AND HAD ASSETS REPRESENTING 59% OF THE TOTAL THRIFT ASSETS IN THE DISTRICT. THE CONDITIONS OF THE INSTITUTIONS WERE NOT JUST THE RESULT OF ECONOMIC AND OPERATING PROBLEMS, BUT HAD BEEN THE TARGET OF INSIDER ABUSE, WHITE COLLAR CRIME AND MISMANAGEMENT.

ENFORCEMENT ACTIONS TAKEN IN 1986 AGAINST INSTITUTIONS AND MANAGEMENT REPRESENTED A 76% INCREASE OVER THOSE TAKEN IN 1985. THE TREND CONTINUED IN 1987, WITH AN ADDITIONAL 130 ACTIONS INITIATED. OF PARTICULAR NOTE IS THAT IN THE YEARS 1986 THROUGH 1988, 141 INSTITUTIONS SIGNED CONSENT/MERGER AGREEMENTS WHICH ESSENTIALLY PROVIDED FSLIC WITH FLEXIBILITY AND AUTHORITY IN DEALING WITH THESE INSOLVENT INSTITUTIONS.

THE EXTENT OF THE PROBLEM IS ADDITIONALLY SHOWN BY THE INCREASE IN CRIMINAL REFERRALS, FROM 535 IN 1986 TO 1,196 IN 1987.

IT IS UNFORTUNATE TO NOTE THAT FEW CASES OF THRIFT FRAUD IN TEXAS HAD BEEN PROSECUTED PRIOR TO 1986 – UNFORTUNATE IN THE CONTEXT OF PREVENTION. IN EARLY 1987, I ESTABLISHED A NEW INVESTIGATIONS DEPARTMENT IN REGULATORY AFFAIRS DIVISION OF THE FHLB CHARGED WITH ASSURING THE COMPLETENESS OF CRIMINAL REFERRALS, LIAISON WITH THE U. S. ATTORNEY AND THE FBI, AND COORDINATING THE ASSISTANCE REQUIRED TO DEVELOP CASES FOR PROSECUTION.

III. WHY IT HAPPENED

THE STORY OF DEREGULATION AND ITS IMPACT ON THE THRIFT INDUSTRY DURING THE LATTER PART OF THE 1970'S AND EARLY 1980'S HAS BEEN DETAILED ON MANY OCCASIONS AND I DON'T BELIEVE IT IS NECESSARY TO COVER IT AGAIN TODAY. INSTEAD, I WOULD PREFER TO HIGHLIGHT CERTAIN ASPECTS OF THAT PERIOD WHICH I BELIEVE WERE PARTICULARLY PERTINENT TO THE SITUATION IN THE SOUTHWEST AND WHICH LED TO THE EXTREMELY EXPENSIVE CIRCUMSTANCES WE ARE FACING TODAY.

FIRST, THE THRIFT INDUSTRY WAS NOT WELL POSITIONED TO DEAL WITH DEREGULATION. OWNERS AND MANAGERS THAT HAD TRADITIONALLY DEALT WITH REAL ESTATE MORTGAGES AND A COST OF FUNDS THAT WAS FIXED BY STATUTE WERE SUDDENLY FACED WITH LEARNING HOW TO DEAL WITH NEW LINES OF BUSINESS INCLUDING COMMERCIAL AND CONSUMER LENDING AND, AT THE SAME TIME, ACQUIRING THE SKILLS TO HANDLE THE MUCH MORE SOPHISTICATED ASSET/LIABILITY MANAGEMENT REQUIREMENTS OF THEIR INSTITUTIONS. IN THE OPINION OF MANY, INCLUDING MYSELF, THERE WAS SIMPLY NOT ENOUGH SKILLED MANAGEMENT TO GO AROUND. AS A RESULT, THE DOOR WAS OPENED FOR LESS PRINCIPLED OWNERS AND OPERATORS TO EXPLOIT THE NEWLY ACQUIRED ADVANTAGES OF THE THRIFT CHARTER.

THOSE OPPORTUNITIES OF DEREGULATION AS PROVIDED BY CONGRESS WERE NOT IN AND OF THEMSELVES ADVERSE. AND, IN FACT, WERE PROVIDED TO HELP A STRUGGLING INDUSTRY ADDRESS ITS OWN PROBLEMS. UNFORTUNATELY, THOSE OPPORTUNITIES COULD BE AND WERE EXPLOITED BY INDIVIDUALS WHOSE PRIMARY MOTIVATION WAS IN QUICK PROFITS. THE SCENARIO WAS SIMPLE. A THRIFT INSTITUTION COULD BE ACQUIRED AT A RELATIVELY LOW COST BECAUSE CAPITAL ACCOUNTS HAD BEEN ADVERSELY IMPACTED BY THE EARLY PRESSURES OF INTEREST RATE LENDING IN THE VERY AGGRESSIVE GROWTH MARKET OF THE SOUTHWEST, AND VIRTUALLY UNLIMITED FUNDING COULD BE OBTAINED THROUGH THE USE OF BROKERED DEPOSITS. PROFITS FROM UP-FRONT FEES COULD BE QUICKLY DRAINED IN THE FORM OF DIVIDENDS, SALARIES AND OTHER INNOVATIVE FORMS OF PROFIT-DIVERSION, AND THE INITIAL INVESTMENT RECOVERED MANY TIMES OVER. OVERALL THE ENVIRONMENT WAS ENTREPRENEURIAL AND QUICK PROFIT RAPIDLY BECAME THE OVERRIDING CRITERIA FOR ANY TRANSACTION. SAFETY AND SOUNDNESS WERE SECONDARY CONSIDERATIONS AT BEST AND THE LINE BETWEEN QUESTIONABLE PRACTICES AND FRAUDULENT SELF-DEALING WAS CROSSED, IN MY OPINION, ON NUMEROUS OCCASIONS.

SECOND, IF ANYTHING, THE SHORTAGE OF SKILLS ON THE SUPERVISION AND EXAMINATION SIDE WAS EVEN MORE ACUTE THAN THE SHORTAGE OF MANAGEMENT IN THE INDUSTRY. DEREGULATION WAS ACTIVELY PROMOTED IN THE EARLY 1980'S BY THE THEN EXISTING BANK BOARD, BUT SCANT THOUGHT IF ANY WAS GIVEN TO BUILDING THE SKILLS OF THE SUPERVISORY STAFF TO UNDERSTAND THE NEW ACTIVITIES PERMITTED TO THE INDUSTRY. TRADITIONALLY, THE SUPERVISORY PROCESSES WERE ORIENTED TO MORTGAGE LENDING AND BASED ON ADHERENCE TO A VERY COMPREHENSIVE AND TIGHTLY STRUCTURED BODY OF REGULATION. OVER A VERY SHORT PERIOD OF TIME SUPERVISORS AND EXAMINERS WERE REQUIRED TO ASSESS INSTITUTIONS THAT WERE ENGAGING IN COMPLETELY NEW LINES OF BUSINESS, EXPANDING RAPIDLY AND, IN A VARIETY OF WAYS MOVING A SUBSTANTIAL DISTANCE FROM THE OPERATIONS OF A TRADITIONAL THRIFT.

UNFORTUNATELY, THIRD IS THE FACT THAT IN THE SAME PERIOD THE REGULATORY PROCESS IN THE THRIFT SYSTEM WAS HAMPERED BY RESTRICTIONS ON THE SIZE OF THE EXAMINATION AND SUPERVISORY FORCE, INITIAL SHORTFALLS VIS-A-VIS BANK SUPERVISORS IN THE PAY LEVELS FOR EXAMINERS, AND A LACK OF TRAINING AND EXPERIENCE IN EXAMINING AND SUPERVISORY SKILLS AND TECHNIQUES. IN MY OPINION THE REGULATORY PROCESS IN THE THRIFT SYSTEM HAS BEEN TRYING TO CATCH UP EVER SINCE.

FOURTH, IMPORTANT SUPERVISORY TOOLS AND TECHNIQUES HAVE ALSO LAGGED BEHIND IN THE THRIFT INDUSTRY. ASSET CLASSIFICATION, ONE OF THE STRONGEST REGULATORY TOOLS, HAS BEEN IN USE BY BANK SUPERVISORS FOR MANY YEARS. IT WAS ONLY INTRODUCED IN THE THRIFT SYSTEM IN LATE 1985. OF COURSE, AS A COMPLETELY NEW APPROACH, IT ALSO REQUIRED TRAINING AND EXPERIENCE TO BE EFFECTIVELY USED.

IN ADDITION, REGULATORY FACTORS ALSO FOSTERED PROBLEMS IN THE INDUSTRY. CAPITAL AND ACCOUNTING STANDARDS INITIALLY EASED TO PROVIDE A RECOVERY OPPORTUNITY FOR THE INDUSTRY AND SUCH ITEMS AS DEFERRED LOSSES AND GOODWILL DID NOT PROVIDE ANY REAL RESTRICTIONS ON GROWTH. AND, IN THE SAME CONTEXT, THOSE SAME ACCOUNTS WERE NOT BUILT UP TO REFLECT THE SUBSTANTIALLY EXPANDED RISK IN THE NEW TYPE OF THRIFT PORTFOLIOS. ADDITIONALLY, THERE WERE NOT ANY REAL RESTRICTIONS ON ENTRY TO THE SYSTEM. WHILE CHANGE OF CONTROL EXISTED AS A CONCEPT, THE REGULATORS ACTUALLY HAD VERY LITTLE GROUNDS FOR DENYING ENTRY SHORT OF PREVIOUS CRIMINAL ACTIVITIES.

FINALLY, THE SEVERE SHORTCOMINGS IN THE REGULATORY SYSTEM THAT I HAVE MENTIONED DID NOT PROVIDE FOR THE TIMELY AND ACCURATE ASSESSMENT OF THE ACTIVITIES, RISKS AND GROWTH THAT WAS OCCURRING IN THIS NEW TYPE OF THRIFT ORGANIZATION. UNFORTUNATELY AND AT THE SAME TIME, THE OTHER CONTROL SYSTEMS THAT HAD TRADITIONALLY PROVIDED SOME MEASURE OF PROTECTION FOR THE SYSTEM AS A WHOLE, I.E. THE APPRAISAL AND ACCOUNTING PROFESSIONS, WERE NOT SUFFICIENT TO CONTROL THOSE SAME NEW AND AGGRESSIVE ORGANIZATIONS.

IT WOULD BE INAPPROPRIATE TO LEAVE THE QUESTION OF WHY PROBLEMS MAY HAVE OCCURRED IN THE THRIFT SYSTEM WITHOUT NOTING THE SHORTCOMINGS OF A TRADITIONALLY VERY CLOSE RELATIONSHIP OF THE THRIFT INDUSTRY AND ITS REGULATOR. EVEN BEFORE THE TRUE CONDITION OF THE INDUSTRY IN THE SOUTHWEST WAS FULLY KNOWN, THE PRESSURES ON THE SUPERVISORY PROCESS BEGAN, PARTICULARLY IN TEXAS. IT IS DIFFICULT FOR ANYONE NOT INVOLVED AT THE TIME TO UNDERSTAND THE HIGHLY CHARGED ATMOSPHERE THAT EXISTED. I CERTAINLY HAD NEVER EXPERIENCED ANYTHING LIKE IT IN MY CAREER AS A BANKING REGULATOR. THE PRESSURES CAME FROM THE MANAGERS OF THE INDUSTRY, BORROWERS, TRADE ASSOCIATIONS, POLITICIANS, AND FROM WITHIN THE FHLBB SYSTEM ITSELF. THE WATCH WORD SEEMED TO BE " IT CAN'T BE AS BAD AS THE REGULATORS SAY IT IS."

THERE WAS PRESSURE ON US TO EASE UP IN OUR SUPERVISORY ACTIVITIES, TO MOLLIFY OUR STRINGENT ENFORCEMENT PROCEDURES, TO APPLY THE ASSET CLASSIFICATION REGULATION LESS STRINGENTLY, AND TO GENERALLY FORBEAR, ALL UNDER THE PERCEPTION THAT THE REGULATORS WERE DESTROYING THE INDUSTRY.

WHILE CERTAINLY NOT CONDONING FRAUD OR EVEN QUESTIONABLE PRACTICES, IT CAN BE ARGUED THAT THE INDUSTRY DID DO MANY THINGS THAT POSTPONED THE ESTABLISHMENT OF THE STRONG REGULATORY POSTURE THAT MIGHT HAVE SIGNIFICANTLY REDUCED THE SUBSTANTIAL COSTS THAT ARE BEING FACED TODAY. IN MY VIEW, OUTLANDISH ACCUSATIONS THAT WOULD BE GIVEN ALMOST NO ATTENTION IN THE BANK REGULATORY ENVIRONMENT WERE ADDRESSED IN THE THE THRIFT SYSTEM TO A DEGREE THAT PREVENTED TIMELY ACTION AND ALLOWED QUESTIONABLE PRACTICES TO CONTINUE.

IV. RECOMMENDATIONS

I HAVE TRIED TO PORTRAY WHAT HAPPENED IN THE THRIFT INDUSTRY IN THE SOUTHWEST AND WHY. THE SCENARIO TODAY IS A MANIFESTATION OF MANY CONCURRENT FAILURES. IT SEEMS EASY TO SINGLE OUT THE SHORTCOMINGS OF THE REGULATORS, BUT JUST AS EASILY CAN FINGERS BE POINTED AT THE INDUSTRY, THE ACCOUNTING FIRMS, THE APPRAISORS, POLITICAL FIGURES AND AT SPECIAL INTEREST GROUPS WHICH PREVENTED NECESSARY LEGISLATION TO BE PASSED WHICH MIGHT HAVE ALLOWED THE PROBLEMS TO BE SOLVED AT REDUCED COSTS AND WHICH MIGHT HAVE DETERRED ADDITIONAL FRAUD.

IT IS PRODUCTIVE TO RECOMMEND MODIFICATIONS NECESSARY TO PREVENT A RECURRENCE OF FUTURE BREAKDOWNS OF THIS MAGNITUDE IN OUR FINANCIAL SYSTEM. MY RECOMMENDATIONS ARE ONLY A FEW THAT CAN BE DONE BY A VARIETY OF INTERESTED PARTIES AND PARTICIPANTS:

1. THE EFFORTS BEGUN BY CHAIRMAN GRAY TO BUILD A STRONG SUPERVISORY SYSTEM WITHIN THE FEDERAL HOME LOAN BANK SYSTEM MUST BE CONTINUED AND ACCELERATED. SUPERVISORY POLICIES AND PROCEDURES MUST BE TAILORED TO A DEREGULATED THRIFT INDUSTRY ENGAGED IN A VARIETY OF NEW POWERS. IT IS APPROPRIATE FOR A REGULATED FINANCIAL INDUSTRY TO COMMENT ON PROPOSED REGULATIONS, BUT IT IS NOT APPROPRIATE FOR THE INDUSTRY TO DICTATE THE SUPERVISORY STRUCTURE CHARGED WITH OVERSEEING CONFORMANCE TO THE REGULATIONS AND THE PRINCIPALS OF SAFETY AND SOUNDNESS.

2. CONTINUITY MUST BE AFFORDED THE KEY OFFICES IN THE FHLBB, IF IT CONTINUES IN ITS PRESENT FORM, PARTICULARLY BY CAREER SUPERVISORS ATTUNED TO THE SUPERVISORY PROCESS IMPERVIOUS TO POLITICAL TURNOVER.

3. TO ASSURE THAT A STRONG SUPERVISORY SYSTEM EXISTS, CONGRESS SHOULD EXPLICITLY LEGISLATE THE INDEPENDENCE OF THE FINANCIAL REGULATORS IN THE AREAS OF BUDGET, SALARIES AND NUMBER OF PERSONNEL.

4. THE INDEPENDENCE OF THE SUPERVISORY FUNCTION MUST BE ASSURED IN THE FHLB SYSTEM AND AT THE VARIOUS FEDERAL HOME LOAN BANKS.

5. PROMPT AND DECISIVE SUPERVISORY AND ENFORCEMENT ACTIONS MUST BE UTILIZED TO STOP ABUSIVE MISMANAGEMENT AND FRAUD AND TO MINIMIZE SUBSEQUENT MONETARY LOSS. THERE MUST BE A WILLINGNESS BY THE SUPERVISORS TO ACT QUICKLY AND RESPONSIBLY, AND EXISTING POWERS EXPANDED OR CLARIFIED BY LEGISLATION IF IN PRESENT FORM THEY CONSTRAIN PROMPTNESS AND EFFECTIVENESS. THE FHLBB HAS SUBMITTED TO CONGRESS AN ENFORCEMENT POWERS BILL.

6. STANDARDS, QUALITY AND CULPABILITY MUST BE REAFFIRMED BY THE ACCOUNTING AND APPRAISAL INDUSTRIES SO THAT VALID RESULTS WILL BE OBTAINED.

7. THE INTEGRITY OF THE REGULATORY PROCESS MUST BE PROTECTED AT ALL COSTS FROM INAPPROPRIATE INTERFERENCE AND INFLUENCE, REGARDLESS OF THE SOURCE.

8. THE BANKING AND THRIFT INDUSTRIES MUST PROVIDE FOR STRONG SELF ENDORSED AND SELF ENFORCED CODE OF ETHICAL PRACTICES AND CONDUCT. INCLUDED SHOULD BE EMPHASIS UPON THE DUTIES AND RESPONSIBILITIES AND LIABILITIES OF FINANCIAL INSTITUTION DIRECTORS, AND APPLICATION OF THE APPROPRIATE PENALTIES PRESCRIBED BY LAW WHEN INTENTIONAL AND FLAGRANT ABUSE IS EVIDENT.

9. A STATUTORY CLARIFICATION IS NEEDED WHICH WOULD GIVE REGULATORS A WIDER LATITUDE IN DENYING ENTRY TO THE INSURANCE-PROTECTED FINANCIAL SERVICES INDUSTRY.

10. SPECIALIZED TRAINING IN THE DETECTION OF FRAUD AND WHITE COLLAR CRIME IS A VITAL PART OF THE TRAINING CURRICULUM NEEDED BY EXAMINERS AND SUPERVISORS. THIS TRAINING SHOULD BE PROVIDED EARLY IN THE CAREER OF EACH PERSON AND CONTINUED AS THE REQUIREMENTS CHANGE.

V. CONCLUSION

THERE ARE MANY VIABLE STEPS THAT CAN BE TAKEN TO DETER ABUSIVE CONDUCT AND FRAUD. I CONSIDER THE MAINTENANCE OF A STRONG SUPERVISORY STRUCTURE TO BE THE KEYSTONE. THE ULTIMATE COST TO THE INSURANCE FUNDS AS A RESULT OF FRAUD IS DIFFICULT TO DETERMINE OR ESTIMATE, ALTHOUGH DIFFERENT FIGURES HAVE BEEN EXPOUNDED. FROM MY VIEWPOINT, THE FIGURE UNDOUBTEDLY WOULD BE VERY HIGH IN DISTRICT NINE OF THE FHLB OF DALLAS, PERHAPS EXCEEDING 50%, AND THAT INSTANCES OF FRAUD OR ABUSIVE SELF DEALING WOULD BE FOUND IN A SIMILARLY LARGE NUMBER OF THE INSOLVENT INSTITUTIONS.

I HOPE THAT MY STATEMENT CAN BE HELPFUL TO YOU. I WILL BE PLEASED TO TRY AND ANSWER ANY QUESTIONS THAT MEMBERS OF THE COMMITTEE MAY HAVE OF ME.

STATEMENT OF

H. JOE SELBY

BEFORE THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

OF THE

UNITED STATES SENATE

WASHINGTON, D. C.

FEBRUARY 9, 1989

I. INTRODUCTION

MR. CHAIRMAN AND DISTINGUISHED MEMBERS OF THE COMMITTEE:

THANK YOU FOR THE INVITATION TO APPEAR BEFORE YOU. I HOPE THAT MY TESTIMONY CAN HELP YOU IN YOUR DELIBERATIONS CONCERNING THE STATE OF THE THRIFT INDUSTRY. I WAS ASKED TO BRIEFLY DISCUSS WHAT I FOUND IN TEXAS RELATIVE TO THE ISSUE OF FRAUD IN THE SAVINGS AND LOAN INDUSTRY, THE CAUSES AND FINALLY, THE SOLUTIONS THAT I MIGHT SUGGEST. I SHALL DO THAT, BUT I THINK SOME PRELIMINARY INFORMATION IS NECESSARY.

FIRST OF ALL, MY BACKGROUND. BEING THE SON OF A COMMERCIAL BANKER, I HAVE BEEN IN THE FINANCIAL SERVICES INDUSTRY MOST OF MY LIFE. MY 32-YEAR CAREER WITH THE OFFICE OF THE COMPTROLLER OF THE CURRENCY ENCOMPASSED MANY POSITIONS, FROM NATIONAL BANK EXAMINER TO ACTING COMPTROLLER. MY BASIC MANAGERIAL FOUNDATION BEGAN WITH RESPONSIBILITIES FOR THE SUPERVISION OF NATIONAL BANKS FROM THE REGIONAL OFFICES OF PORTLAND, OREGON AND SAN FRANCISCO, CALIFORNIA. IN 1975, I ASSUMED THE TOP CAREER POSITION IN WASHINGTON AS SENIOR DEPUTY COMPTROLLER. MY IMMEDIATE CHARGE WAS THE DEVELOPMENT AND IMPLEMENTATION OF THE MOST COMPREHENSIVE MODERNIZATION OF THE SUPERVISORY PROCESS SINCE THE CREATION OF THE AGENCY. THE NEXT 12 YEARS OF MY CAREER REFLECTED A CONTINUATION IN THE REFINEMENT OF SUPERVISORY TECHNIQUES, INCLUDING THE UTILIZATION OF COMPUTER TECHNOLOGY; THE MANAGEMENT AND RESOLUTION OF VERY LARGE NATIONAL BANK FAILURES IN THE U.S. INCLUDING CONTINENTAL ILLINOIS; AND THE LIAISON FOR THE COMPTROLLER WITH FOREIGN BANK SUPERVISORS, INCLUDING MEMBERSHIP ON THE COMMITTEE OF BANKING REGULATION AND SUPERVISION OF THE BANK OF INTERNATIONAL SETTLEMENTS IN BASLE, SWITZERLAND. INHERENT IN ALL OF MY SUPERVISORY ACTIVITIES WAS THE USE OF ENFORCEMENT POWERS IN CASES OF MISMANAGEMENT AND FRAUD.

I WAS A SUPERVISOR OF THE THRIFT INDUSTRY IN TEXAS FOR ONLY A SHORT 2-YEAR PERIOD (1986 - 1988), BUT THE TIME - IN MY MIND - EQUATED TO ANOTHER WHOLE CAREER EXCEEDING THE 32-YEARS WITH THE OCC. WHAT I FOUND IN DALLAS IN MAY, 1986, WAS A FINANCIAL AND A REGULATORY SYSTEM AND SITUATION UNLIKE ANY THAT I HAD EVER ENCOUNTERED.

I WAS HIRED BY THE THEN-PRESIDENT OF THE FEDERAL HOME LOAN BANK OF DALLAS, ROY GREEN, TO UTILIZE MY EXTENSIVE SUPERVISORY EXPERIENCE AND KNOWLEDGE AS A BANKING REGULATOR TO INSTITUTE ORGANIZATIONAL AND PROCEDURAL CHANGES IN THE REGULATORY SIDE OF THE DALLAS BANK WHICH WOULD RESULT IN A MORE RESPONSIVE AND EFFECTIVE SUPERVISORY MECHANISM. MY EMPLOYMENT WITH THE BANK WAS STRONGLY ENCOURAGED BY FORMER CHAIRMAN ED GRAY AND BY FORMER BOARD MEMBER DON HOVDE.

MY EFFORTS TO SUPPLANT AN EXISTING SUPERVISORY PROCESS WITH ONE EQUAL TO THE TASK AT HAND WERE CONSIDERABLY COMPLICATED BY THE MASSIVE EFFORTS UNDERWAY TO IDENTIFY AND ADDRESS PROBLEMS IN ALMOST 500 SAVINGS AND LOAN INSTITUTIONS IN THE FIVE-STATE DISTRICT. THOSE PROBLEMS ENCOMPASSED MASSIVE FRAUD, RAMPANT SELF-DEALING AND ABUSIVE CONFLICTS OF INTEREST, MISMANAGEMENT, AND THE 200 OR MORE THRIFT INSTITUTIONS THAT WERE ON THE VERGE OF INSOLVENCY OR WERE ACTUALLY INSOLVENT. WHILE THE BURSTING OF THE ECONOMIC BUBBLE IN THE SOUTHWEST ADDED TO THE DIFFICULTY IN THE RESOLUTION OF THE PROBLEMS, THE PROBLEMS THEMSELVES WERE IN LARGE PART CREATED BY AN ECONOMY FUELED BY THE UNRESTRAINED LENDING OF THE FINANCIAL INSTITUTIONS.

THE HIGH VISIBILITY OF THE PROBLEMS IN THE THRIFT INDUSTRY IN THE SOUTHWEST, PARTICULARLY TEXAS, AND MY OWN HIGH VISIBILITY AS A REGULATOR NATURALLY INVOLVED ME IN ISSUES BOTH AT THE REGIONAL AND NATIONAL LEVELS. I ACTIVELY PARTICIPATED IN CONGRESSIONAL TESTIMONY, WORKED WITH MEMBERS OF THE BANK BOARD ON SUPERVISORY POLICY MATTERS OF ALL TYPES, AND HAD DAY TO DAY CONTACT WITH ALL OF THE VARIOUS DIVISIONS OF THE BANK BOARD SYSTEM. I WOULD LIKE TO PARTICULARLY NOTE THAT CHAIRMAN GRAY WAS AN ACTIVE SUPPORTER OF MY EFFORTS DURING THE SUBSEQUENT PERIOD OF UNBELIEVABLE TENSIONS AND PRESSURES ON THE SUPERVISORY PROCESS AT THE DALLAS BANK.

BEFORE STARTING THE SUBSTANCE OF MY TESTIMONY I WOULD LIKE TO MAKE TWO POINTS. FIRST, IN DISCUSSING ANY FINDINGS OF ALLEGED FRAUD AND THE CAUSES THEREOF, I WILL NOTE MY RESERVATION IN IDENTIFYING SPECIFIC INDIVIDUALS OR FINANCIAL INSTITUTIONS WHICH MIGHT BE INVOLVED IN CRIMINAL REFERRALS. SECONDLY, THE DEFINITION OF FRAUD IS NARROWLY DEFINED BY STATUTE AS THE "WILLFUL MISAPPLICATION OF FUNDS, FALSE STATEMENTS, KICKBACKS, CONSPIRACY, ETC." AS A REGULATOR, I INCLUDE THE FLAGRANT PRACTICES OF SELF DEALING AND DELETERIOUS CONFLICTS OF INTERESTS BECAUSE OF THE DAMAGE SUCH PRACTICES CAN CAUSE TO A FINANCIAL INSTITUTION. I ALSO CONSIDER ALMOST EQUALLY AS SERIOUS THE MISMANAGEMENT OF A FINANCIAL INSTITUTION THROUGH VIOLATIONS OF THE BASIC TENETS OF SAFETY AND SOUNDNESS PRINCIPLES WHICH UNDERMINE THE STRENGTH OF THE INSTITUTION AND WHICH RESULT IN EXPOSURE TO THE INSURANCE FUNDS. THESE ARE ALL JUXTAPOSED IN ANY DISCUSSION OF THE PROBLEMS FOUND IN THE THRIFT INDUSTRY IN THE SOUTHWEST.

II. EXISTING CONDITIONS

UPON ARRIVING IN DALLAS, MAY 1, 1986, I FOUND THAT OF THE APPROXIMATELY 500 MEMBER SAVINGS AND LOAN INSTITUTIONS IN DISTRICT NINE, A MAJORITY HAD NOT BEEN COMPREHENSIVELY EXAMINED IN 2 OR 3 YEARS. IT IS IMPORTANT TO NOTE THAT DURING THIS SAME TIME FRAME THE INSTITUTIONS WERE EXPERIENCING RAPID GROWTH PARTICULARLY IN ACQUISITION, DEVELOPMENT, AND CONSTRUCTION LOANS FUNDED BY BROKERED DEPOSITS, AND OFTEN THE "ENTREPRENEURIAL" OWNERS/MANAGERS WERE SYSTEMATICALLY TAKING THE UPFRONT LOAN FEES GENERATED IN THAT GROWTH OUT OF THE INSTITUTIONS IN THE FORM OF LARGE SALARIES, DIVIDENDS, AND OTHER FORMS OF REMUNERATION.

FORMER CHAIRMAN ED GRAY REALIZED THAT SERIOUS PROBLEMS WERE DEVELOPING AND TOOK MANY ACTIONS TO CURTAIL THE INAPPROPRIATE ACTIVITIES. HE ISSUED, AMONG OTHERS, REGULATIONS THAT ADDRESSED GROWTH, DIRECT INVESTMENT, CAPITAL, AND CLASSIFICATION OF ASSETS. FURTHERMORE, IN THE FIRST QUARTER OF 1986 HE SENT EXAMINERS FROM TEN (10) OF THE ELEVEN (11) OTHER FEDERAL HOME LOAN BANKS TO ASSIST DALLAS IN EXAMINING APPROXIMATELY 300 MEMBER INSTITUTIONS. THE RESULTS OF THOSE EXAMINATIONS BEGAN TO BE FINALIZED AFTER I ARRIVED AND REVEALED A SERIOUS IMPAIRMENT OF THE INDUSTRY.

THUS, AS I HAVE MENTIONED, MY PRIMARY TASK OF UPDATING THE SUPERVISORY PRACTICES AT THE DALLAS BANK WAS COMPLICATED BY THE DAY-TO-DAY RESPONSIBILITIES OF ADDRESSING PROBLEMS OVERALL. THE STAFF WAS DELUGED WITH DRAFTING AND IMPLEMENTING ENFORCEMENT ACTIONS, REMOVAL AND REPLACEMENT OF MANAGEMENT, THE FILING OF CRIMINAL REFERRALS, REQUESTS FOR LIQUIDATIONS OF INSTITUTIONS BY FSLIC, AND APPLICATION OF THE NEW ASSET CLASSIFICATION REGULATION. EVEN WITH SIZEABLE STAFF ADDITIONS, THE TIME CONSTRAINTS AND THE SUPERVISORY NEEDS OF THE DISTRICT, NOT TO MENTION THE SYSTEM, PLACED ALMOST UNREASONABLE BURDENS ON ALL THE EXAMINING AND SUPERVISORY STAFF.

CHARTS ATTACHED AT THE END ARE ILLUSTRATIVE OF THE SUBSTANTIAL NUMBER OF PROBLEM INSTITUTIONS IDENTIFIED IN 1986 AND 1987 AND THE CONCOMITANT INCREASE IN SUPERVISORY AND ENFORCEMENT ACTIONS AND CRIMINAL REFERRALS INITIATED. AS OF MARCH 31, 1987, STAFF HAD IDENTIFIED 191 FINANCIAL INSTITUTIONS IN THE NINTH DISTRICT AS COMPRISING THE GREATEST RISK TO FSLIC. THESE INSTITUTIONS HAD ASSETS THAT REPRESENTED 59% OF THE TOTAL THRIFT ASSETS IN THE DISTRICT. PROBLEMS WITH THE INSTITUTIONS WERE NOT JUST CONFINED TO ECONOMIC AND OPERATING PROBLEMS. AS THE STATISTICS CLEARLY REVEAL, TEXAS THRIFTS IN PARTICULAR HAVE BEEN THE TARGET OF INSIDER ABUSE, WHITE COLLAR CRIME, AND MISMANAGEMENT.

ENFORCEMENT ACTIONS TAKEN IN 1986 AGAINST INSTITUTIONS AND MANAGEMENT REPRESENTED A 76% INCREASE OVER THOSE TAKEN IN 1985. THE TREND CONTINUED IN 1987, WITH AN ADDITIONAL 130 ACTIONS INITIATED. OF PARTICULAR NOTE IS THAT IN THE YEARS 1986 THROUGH 1988, 141 INSTITUTIONS SIGNED CONSENT/MERGER AGREEMENTS WHICH DENOTED INSOLVENCY AND ESSENTIALLY PROVIDED FSLIC WITH FLEXIBILITY AND AUTHORITY FOR ARRANGING THEIR FINAL RESOLUTION.

AS FURTHER INDICATION OF THE EXTENT OF THE PROBLEM, PARTICULARLY WITH REGARD TO FRAUD, CONSIDER THAT 535 INDIVIDUAL CRIMINAL REFERRALS WERE SUBMITTED TO THE DEPARTMENT OF JUSTICE IN 1986. THAT FIGURE INCREASED TO 1,196 REFERRALS IN THE YEAR 1987 AND THE BULK OF THOSE CRIMINAL REFERRALS WERE IN THRIFTS IN THE STATE OF TEXAS.

IN THE CONTEXT OF PREVENTION, IT IS UNFORTUNATE TO ALSO NOTE THAT VERY FEW CASES OF THRIFT FRAUD IN TEXAS HAD BEEN PROSECUTED PRIOR TO 1986. I LEARNED FROM MY EXPERIENCE AS A BANKING REGULATOR THAT CASES BEFORE THE UNITED STATES ATTORNEY'S OFFICE WERE OFTEN COMPLEX AND REQUIRED ADDITIONAL ASSISTANCE FROM THE REGULATOR IN DEVELOPING THE FACTS OF A CASE. LITTLE SUPPORT WAS BEING GIVEN TO THAT PROCESS BY THE FEDERAL HOME LOAN BANK OF DALLAS. IN EARLY 1987, I ESTABLISHED A NEW INVESTIGATIONS DEPARTMENT IN REGULATORY AFFAIRS WHOSE PRIMARY FUNCTIONS CONSISTED OF ASSURING THE COMPLETENESS OF CRIMINAL REFERRALS, LIAISON WITH THE U.S. ATTORNEY AND THE FBI, AND COORDINATING WITH THE U.S. ATTORNEY THE ASSISTANCE REQUIRED FROM THE REGULATOR TO DEVELOP CASES. IN ADDITION TO STAFFING THE UNIT, I ALSO COMMITTED RESOURCES AND ACTUALLY ASSIGNED FOUR (4) SUPERVISORY/EXAMINER PERSONNEL TO THE U.S. ATTORNEY AND THE GRAND JURY PROCESS FOR TERMS OF UP TO TWO (2) YEARS.

III. WHY IT HAPPENED

THE STORY OF DEREGULATION AND ITS IMPACT ON THE THRIFT INDUSTRY DURING THE LATTER PART OF THE 1970'S AND EARLY 1980'S HAS BEEN DETAILED ON MANY OCCASIONS AND I DON'T BELIEVE IT IS NECESSARY TO COVER IT AGAIN TODAY. INSTEAD, I WOULD PREFER TO HIGHLIGHT CERTAIN ASPECTS OF THAT PERIOD WHICH I BELIEVE WERE PARTICULARLY PERTINENT TO THE SITUATION IN THE SOUTHWEST AND WHICH LED TO THE EXTREMELY EXPENSIVE CIRCUMSTANCES WE ARE FACING TODAY.

FIRST, THE THRIFT INDUSTRY WAS NOT WELL POSITIONED TO DEAL WITH DEREGULATION. OWNERS AND MANAGERS THAT HAD TRADITIONALLY DEALT WITH REAL ESTATE MORTGAGES AND A COST OF FUNDS THAT WAS FIXED BY STATUTE WERE SUDDENLY FACED WITH LEARNING HOW TO DEAL WITH NEW LINES OF BUSINESS INCLUDING COMMERCIAL AND CONSUMER LENDING AND, AT THE SAME TIME, ACQUIRING THE SKILLS TO HANDLE THE MUCH MORE SOPHISTICATED ASSET/LIABILITY MANAGEMENT REQUIREMENTS OF THEIR INSTITUTIONS. IN THE OPINION OF MANY, INCLUDING MYSELF, THERE WAS SIMPLY NOT ENOUGH SKILLED MANAGEMENT TO GO AROUND. AS A RESULT, THE DOOR WAS OPENED FOR LESS PRINCIPLED OWNERS AND OPERATORS TO EXPLOIT THE NEWLY ACQUIRED ADVANTAGES OF THE THRIFT CHARTER.

THOSE OPPORTUNITIES OF DEREGULATION AS PROVIDED BY CONGRESS WERE NOT IN AND OF THEMSELVES ADVERSE. AND, IN FACT, WERE PROVIDED TO HELP A STRUGGLING INDUSTRY ADDRESS ITS OWN PROBLEMS. UNFORTUNATELY, THOSE OPPORTUNITIES COULD BE AND WERE EXPLOITED BY INDIVIDUALS WHOSE PRIMARY MOTIVATION WAS IN QUICK PROFITS. THE SCENARIO WAS SIMPLE. A THRIFT INSTITUTION COULD BE ACQUIRED AT A RELATIVELY LOW COST BECAUSE CAPITAL ACCOUNTS HAD BEEN ADVERSELY IMPACTED BY THE EARLY PRESSURES OF INTEREST RATE LENDING IN THE VERY AGGRESSIVE GROWTH MARKET OF THE SOUTHWEST, AND VIRTUALLY UNLIMITED FUNDING COULD BE OBTAINED THROUGH THE USE OF BROKERED DEPOSITS. PROFITS FROM UP-FRONT FEES COULD BE QUICKLY DRAINED IN THE FORM OF DIVIDENDS, SALARIES AND OTHER INNOVATIVE FORMS OF PROFIT-DIVERSION, AND THE INITIAL INVESTMENT RECOVERED MANY TIMES OVER. OVERALL THE ENVIRONMENT WAS ENTREPRENEURIAL AND QUICK PROFIT RAPIDLY BECAME THE OVERRIDING CRITERIA FOR ANY TRANSACTION. SAFETY AND SOUNDNESS WERE SECONDARY CONSIDERATIONS AT BEST AND THE LINE BETWEEN QUESTIONABLE PRACTICES AND FRAUDULENT SELF-DEALING WAS CROSSED, IN MY OPINION, ON NUMEROUS OCCASIONS.

SECOND, IF ANYTHING, THE SHORTAGE OF SKILLS ON THE SUPERVISION AND EXAMINATION SIDE WAS EVEN MORE ACUTE THAN THE SHORTAGE OF MANAGEMENT IN THE INDUSTRY. DEREGULATION WAS ACTIVELY PROMOTED IN THE EARLY 1980'S BY THE THEN EXISTING BANK BOARD, BUT SCANT THOUGHT IF ANY WAS GIVEN TO BUILDING THE SKILLS OF THE SUPERVISORY STAFF TO UNDERSTAND THE NEW ACTIVITIES PERMITTED TO THE INDUSTRY. TRADITIONALLY, THE SUPERVISORY PROCESSES WERE ORIENTED TO MORTGAGE LENDING AND BASED ON ADHERENCE TO A VERY COMPREHENSIVE AND TIGHTLY STRUCTURED BODY OF REGULATION. OVER A VERY SHORT PERIOD OF TIME SUPERVISORS AND EXAMINERS WERE REQUIRED TO ASSESS INSTITUTIONS THAT WERE ENGAGING IN COMPLETELY NEW LINES OF BUSINESS, EXPANDING RAPIDLY AND, IN A VARIETY OF WAYS MOVING A SUBSTANTIAL DISTANCE FROM THE OPERATIONS OF A TRADITIONAL THRIFT. IN TEXAS THAT TASK WAS EVEN MORE COMPLICATED BECAUSE OF THE VERY BROAD POWERS, PARTICULARLY IN THE AREA OF DIRECT INVESTMENT, THAT WERE PROVIDED TO STATE CHARTERED INSTITUTIONS.

UNFORTUNATELY, THIRD IS THE FACT THAT IN THE SAME PERIOD THE REGULATORY PROCESS IN THE THRIFT SYSTEM WAS HAMPERED BY RESTRICTIONS ON THE SIZE OF THE EXAMINATION AND SUPERVISORY FORCE, INITIAL SHORTFALLS VIS-A-VIS BANK SUPERVISORS IN THE PAY LEVELS FOR EXAMINERS, AND A LACK OF TRAINING AND EXPERIENCE IN EXAMINING AND SUPERVISORY SKILLS AND TECHNIQUES. IN MY OPINION THE REGULATORY PROCESS IN THE THRIFT SYSTEM HAS BEEN TRYING TO CATCH UP EVER SINCE. AN EXAMPLE MAY SERVE TO ILLUSTRATE THAT SITUATION. IN THE EARLY 1980'S THE FEDERAL HOME LOAN BANK MOVED FROM LITTLE ROCK TO DALLAS. AT THAT POINT THE ENTIRE SUPERVISORY STAFF WAS ABLE TO MEET IN ONE SMALL CONFERENCE ROOM AND CASELOADS OF 40 TO 50 INSTITUTIONS WERE NOT UNCOMMON. ULTIMATELY, IN RESPONSE, THE EXAMINATION STAFF WAS REASSIGNED TO THE BANK FROM THE FHLBB AND THE HIRING OF LITERALLY HUNDREDS OF SUPERVISORS AND EXAMINERS TOOK PLACE IN A VERY SHORT PERIOD OF TIME. HOWEVER, THAT GREATLY EXPANDED STAFF REQUIRED PRACTICAL TECHNICAL TRAINING IN ALMOST ALL ASPECTS OF THE WORK AT THE SAME TIME SUBSTANTIAL DEMANDS WERE BEING PLACED ON THE SYSTEM TO DEAL WITH THE NEW POWERS AND EXPANSION I HAVE NOTED.

FOURTH, IMPORTANT SUPERVISORY TOOLS AND TECHNIQUES HAVE ALSO LAGGED BEHIND IN THE THRIFT INDUSTRY. ASSET CLASSIFICATION, ONE OF THE STRONGEST REGULATORY TOOLS, HAS BEEN IN USE BY BANK SUPERVISORS FOR MANY YEARS. IT WAS ONLY INTRODUCED IN THE THRIFT SYSTEM IN LATE 1985. OF COURSE, AS A COMPLETELY NEW APPROACH, IT ALSO REQUIRED TRAINING AND EXPERIENCE TO BE EFFECTIVELY USED. ANOTHER CRITICAL EXAMPLE RESTS IN THE USE OF COMPUTERIZED SYSTEMS. WHEN I JOINED THE FHLB OF DALLAS, EXAMINERS WERE STILL WRITING REPORTS IN PENCIL AND SENDING THEM IN FOR TYPING. THAT SITUATION HAS CHANGED SUBSTANTIALLY SINCE. BUT AGAIN THAT TRANSITION REQUIRED TRAINING, TIME AND EXPERIENCE TO BE EFFECTIVE.

IN ADDITION, REGULATORY FACTORS ALSO FOSTERED PROBLEMS IN THE INDUSTRY. CAPITAL AND ACCOUNTING STANDARDS INITIALLY EASED TO PROVIDE A RECOVERY OPPORTUNITY FOR THE INDUSTRY AND SUCH ITEMS AS DEFERRED LOSSES AND GOODWILL DID NOT PROVIDE ANY REAL RESTRICTIONS ON GROWTH. AND, IN THE SAME CONTEXT, THOSE SAME ACCOUNTS WERE NOT BUILT UP TO REFLECT THE SUBSTANTIALLY EXPANDED RISK IN THE NEW TYPE OF THRIFT PORTFOLIOS. ADDITIONALLY, THERE WERE NOT ANY REAL RESTRICTIONS ON ENTRY TO THE SYSTEM. WHILE CHANGE OF CONTROL EXISTED AS A CONCEPT, THE REGULATORS ACTUALLY HAD VERY LITTLE GROUNDS FOR DENYING ENTRY SHORT OF PREVIOUS CRIMINAL ACTIVITIES.

FINALLY, THE SEVERE SHORTCOMINGS IN THE REGULATORY SYSTEM THAT I HAVE MENTIONED DID NOT PROVIDE FOR THE TIMELY AND ACCURATE ASSESSMENT OF THE ACTIVITIES, RISKS AND GROWTH THAT WAS OCCURRING IN THIS NEW TYPE OF THRIFT ORGANIZATION. UNFORTUNATELY AND AT THE SAME TIME, THE OTHER CONTROL SYSTEMS THAT HAD TRADITIONALLY PROVIDED SOME MEASURE OF PROTECTION FOR THE SYSTEM AS A WHOLE, I.E. THE APPRAISAL AND ACCOUNTING PROFESSIONS, WERE NOT SUFFICIENT TO CONTROL THOSE SAME NEW AND AGGRESSIVE ORGANIZATIONS.

IT WOULD BE INAPPROPRIATE TO LEAVE THE QUESTION OF WHY PROBLEMS MAY HAVE OCCURRED IN THE THRIFT SYSTEM WITHOUT NOTING THE SHORTCOMINGS OF A TRADITIONALLY VERY CLOSE RELATIONSHIP OF THE THRIFT INDUSTRY AND ITS REGULATOR. EVEN BEFORE THE TRUE CONDITION OF THE INDUSTRY IN THE SOUTHWEST WAS FULLY KNOWN, THE PRESSURES ON THE SUPERVISORY PROCESS BEGAN, PARTICULARLY IN TEXAS. IT IS DIFFICULT FOR ANYONE NOT INVOLVED AT THE TIME TO UNDERSTAND THE HIGHLY CHARGED ATMOSPHERE THAT EXISTED. I CERTAINLY HAD NEVER EXPERIENCED ANYTHING LIKE IT IN MY CAREER AS A BANKING REGULATOR. THE PRESSURES CAME FROM THE MANAGERS OF THE INDUSTRY, BORROWERS, TRADE ASSOCIATIONS, POLITICIANS, AND FROM WITHIN THE FHLBB SYSTEM ITSELF. THE WATCH WORD SEEMED TO BE " IT CAN'T BE AS BAD AS THE REGULATORS SAY IT IS."

THERE WAS PRESSURE ON US TO EASE UP IN OUR SUPERVISORY ACTIVITIES, TO MOLLIFY OUR STRINGENT ENFORCEMENT PROCEDURES, TO APPLY THE ASSET CLASSIFICATION REGULATION LESS STRINGENTLY, AND TO GENERALLY FORBEAR, ALL UNDER THE PERCEPTION THAT THE REGULATORS WERE DESTROYING THE INDUSTRY.

WHILE CERTAINLY NOT CONDONING FRAUD OR EVEN QUESTIONABLE PRACTICES, IT CAN BE ARGUED THAT THE INDUSTRY DID DO MANY THINGS THAT POSTPONED THE ESTABLISHMENT OF THE STRONG REGULATORY POSTURE THAT MIGHT HAVE SIGNIFICANTLY REDUCED THE SUBSTANTIAL COSTS THAT ARE BEING FACED TODAY. IN MY VIEW, OUTLANDISH ACCUSATIONS THAT WOULD BE GIVEN ALMOST NO ATTENTION IN THE BANK REGULATORY ENVIRONMENT WERE ADDRESSED IN THE THE THRIFT SYSTEM TO A DEGREE THAT PREVENTED TIMELY ACTION AND ALLOWED QUESTIONABLE PRACTICES TO CONTINUE.

IV. RECOMMENDATIONS

MY TESTIMONY IS INTENDED TO PORTRAY WHAT HAD HAPPENED IN THE THRIFT INDUSTRY IN THE SOUTHWEST AND THE LEADING CAUSES THEREOF. IN MY OPINION THE SCENARIO TODAY IS A MANIFESTATION OF MANY CONCURRENT FAILURES. IT SEEMS EASY TO SINGLE OUT THE SHORTCOMINGS OF THE REGULATORS, AND CERTAINLY THE REGULATORY SYSTEM IS SOMEWHAT AT FAULT. BUT JUST AS EASILY CAN FINGERS BE POINTED AT THE INDUSTRY ITSELF; AT THE ACCOUNTING FIRMS, THE APPRAISAL INDUSTRY, POLITICAL FORCES AND SPECIAL INTEREST GROUPS WHICH PREVENTED THE PASSAGE OF NECESSARY LEGISLATION WHICH MIGHT HAVE ALLOWED THE PROBLEMS TO BE SOLVED, THE ULTIMATE COST REDUCED AND DETERRED FRAUD.

BUT IT IS NOT PARTICULARLY PRODUCTIVE TO POINT FINGERS UNLESS IT RESULTS IN THE NECESSARY MODIFICATIONS TO PREVENT A RECURRENCE. MY RECOMMENDATIONS, THEREFORE, ADDRESS WHAT MUST BE DONE BY A VARIETY OF PARTICIPANTS AND INTERESTED PARTIES TO HELP INSURE THAT OUR FINANCIAL SYSTEM DOES NOT SUFFER THIS TYPE OF BREAKDOWN IN THE FUTURE. CERTAINLY, THE FHLBB HAS UNDERTAKEN A VARIETY OF ACTIONS TO IMPROVE SUPERVISION AND IN COORDINATING WITH THE DEPARTMENT OF JUSTICE PROBLEMS ON FOUND IN FRAUD RELATED SITUATIONS.

A STRONG SUPERVISORY STRUCTURE

THE U.S. SYSTEM OF INSURING PUBLIC CONFIDENCE IN OUR FINANCIAL SYSTEM IS UNIQUE AMONG NATIONS, THAT IS, A SYSTEM BASED UPON FINANCIAL DISCLOSURE, DEPOSIT INSURANCE AND A STRUCTURED SYSTEM OF SUPERVISION. MY FIRST RECOMMENDATION IS THAT THE EFFORTS STARTED BY CHAIRMAN ED GRAY TO BUILD A STRONG SUPERVISORY SYSTEM WITHIN THE FEDERAL HOME LOAN BANK SYSTEM BE CONTINUED AND ACCELERATED. THIS IS PARTICULARLY IMPORTANT WHEN VIEWED IN THE CONTEXT THAT AN EXISTING MENTALITY FOCUSED ON AN INDUSTRY ONCE DOMINATED BY SINGLE FAMILY MORTGAGE LENDING IS NO LONGER APPROPRIATE. RESISTANCE TO CHANGE MUST BE OVERCOME BY THE DEVELOPMENT AND IMPLEMENTATION OF SUPERVISORY POLICIES AND PROCEDURES THAT ARE TAILORED TO A DEREGULATED THRIFT INDUSTRY ENGAGED IN SPECIALIZED AND COMPLEX LENDING AND INVESTMENT PRACTICES. IT IS APPROPRIATE FOR A REGULATED INDUSTRY TO COMMENT ON PROPOSED REGULATIONS WHICH IMPACT ITS OPERATIONS BUT IT IS NOT APPROPRIATE FOR THE INDUSTRY TO DICTATE HOW A SUPERVISORY STRUCTURE WILL BE BUILT TO OVERSEE CONFORMANCE WITH THE REGULATIONS AND THE PRINCIPALS OF SAFETY AND SOUNDNESS.

CONTINUITY OF SUPERVISORY MANAGEMENT

IT IS MY OWN VIEW THAT PROGRESS IS BEING MADE IN BUILDING THAT MORE EFFECTIVE SUPERVISORY STRUCTURE. UNFORTUNATELY THE FHLBB'S KEY OFFICES HAVE BEEN TRADITIONALLY SUBJECT TO TURNOVER AT THE TOP UPON THE CHANGE IN THE CHAIRMANSHIP. AS A RESULT, CONTINUITY HAS BEEN PARTICULARLY LACKING IN THE KEY AREAS OF REGULATORY ACTIVITIES. IT IS MY RECOMMENDATION THAT IF THE FHLBB CONTINUES IN ITS PRESENT FORM, THESE KEY OFFICES BE HEADED BY CAREER SUPERVISORS ATTUNED TO THE PROCESS AND IMPERVIOUS TO POLITICAL TURNOVER.

CAPABLE AND EXPERIENCED SUPERVISORY STAFF

THE SUCCESS OF ANY SUPERVISORY STRUCTURE WITH CAN ONLY BE ASSURED THROUGH THE MAINTENANCE OF ADEQUATE NUMBERS OF CAPABLE AND EXPERIENCED STAFF. IN ADDITION TO FAILURE TO REACT SOON ENOUGH TO A DEREGULATED ENVIRONMENT, THE BANK BOARD WAS ALSO HAMPERED BY ARTIFICIAL PERSONNEL CEILINGS IMPOSED BY THE OFFICE OF MANAGEMENT AND BUDGET AND RESTRICTIONS ON THE PAYMENT OF COMPETITIVE SALARIES, BOTH OF WHICH IMPACTED THE EXAMINING STAFF. CONGRESS SHOULD EXPLICITLY LEGISLATE THE INDEPENDENCE OF THE FINANCIAL REGULATORS IN THE AREAS OF BUDGET, SALARIES, AND NUMBER OF PERSONNEL.

INDEPENDENCE OF SUPERVISORY FUNCTION

I FIRMLY BELIEVE THAT SOME DEGREE OF INDEPENDENCE IS NECESSARY WITHIN A BANKING OR THRIFT REGULATORY SYSTEM. WITHIN THE FEDERAL HOME LOAN BANK SYSTEM SEVERAL CONTRADICTIONS EXIST WHICH DO NOT PROVIDE FOR THAT NECESSARY INDEPENDENCE. FIRST, IN SOME OF THE FEDERAL HOME LOAN BANKS, THE SUPERVISORY BUDGET MUST RECEIVE AN APPROVAL BY THAT BANK'S BOARD OF DIRECTORS. THE MAJORITY OF THAT BOARD ARE MEMBERS OF THE INDUSTRY; THE REGULATED. MONIES ALLOCATED TO THE SUPERVISORY PROCESS SHOULD BE SUBJECT TO ONLY THE APPROVAL OF THE FEDERAL HOME LOAN BANK BOARD.

THE SECOND CONTRADICTION IS THAT THE CHIEF REGULATOR AT THE FEDERAL HOME LOAN BANK LEVEL, THE PRINCIPAL SUPERVISORY AGENT, IS ALSO THE PRESIDENT OF THE BANK ELECTED BY AND ANSWERABLE TO THE BANK'S BOARD OF DIRECTORS: AGAIN, THE REGULATED. THIS CONFLICT POSES THE POSSIBILITY OF AN APPROPRIATE SUPERVISORY RESPONSE BEING DELAYED, MODIFIED OR EVEN ELIMINATED. IN THIS REGARD, I RECOMMEND THAT SUPERVISORY MATTERS BE HANDLED BY A CAREER SUPERVISOR IN EACH BANK WHO IS RESPONSIBLE TO THE FHLBB ON SUPERVISORY MATTERS.

STRONG AND EFFECTIVE ENFORCEMENT

STRONG ENFORCEMENT POLICIES AND PRACTICES CAN BE USED EFFECTIVELY TO DETER THE OCCURRENCE OF FRAUD AND ABUSIVE SELF DEALING AND CONFLICTS OF INTEREST. IN MY EXPERIENCE, PROMPT AND DECISIVE SUPERVISORY ACTION CAN STOP ABUSIVE MISMANAGEMENT AND FRAUD AND, IN FACT, MINIMIZE SUBSEQUENT MONETARY LOSSES. TWO THINGS CAN CREATE A LOSS OF THAT OPPORTUNITY: A TIMIDITY OR UNWILLINGNESS TO TAKE PROMPT ACTION BECAUSE OF A PERCEIVED WEAK LEGAL BASIS OR IF THE EXISTING POWERS THEMSELVES CONSTRAIN PROMPTNESS AND EFFECTIVENESS.

TWO VERY VALUABLE SUPERVISORY TOOLS PROVIDED TO THE BANK BOARD NOW BY STATUTE ARE CONSTRAINED IN THIS MANNER. FIRST IS THE ABILITY TO TERMINATE INSURANCE AND SECOND IS THE ABILITY TO IMPOSE CIVIL MONEY PENALTIES. IN THE FORMER, THE PROCESS OF TERMINATION OF INSURANCE IS LABORIOUS AND TIME CONSUMING AND THEREFORE IS SELDOM IF EVER UTILIZED. IN THE LATTER IT IS MY UNDERSTANDING THAT THE ABILITY OF THE FHLBB TO IMPOSE CIVIL MONEY PENALTIES IS MORE DIFFICULT THAN THAT OF THE BANKING AGENCIES AND IS THEREFORE SELDOM UTILIZED.

WHILE I DO NOT DISPUTE THAT A SOUND BASIS MUST BE PRESENT TO JUSTIFY ANY SUPERVISORY OR ENFORCEMENT ACTION, IT SEEMS THAT ALL TOO OFTEN THE FEAR OF LOSING A CASE AND THUS SETTING AN UNFAVORABLE PRECEDENT OVERRIDES THE DECISION TO TAKE PROMPT ACTION. THIS SITUATION CAN BE CHANGED BY APPROPRIATE CONGRESSIONAL ACTION. AN ENFORCEMENT POWERS BILL WAS SUBMITTED TO CONGRESS BY THE FHLBB IN DECEMBER 1987 AND CONTAINS MANY ASPECTS WHICH WOULD SIGNIFICANTLY STRENGTHEN THESE AND OTHER ENFORCEMENT POWERS ALONG THE LINES I HAVE MENTIONED. A SUMMARY OF THAT BILL PREPARED BY THE FHLBB IS ATTACHED.

IMPROVED STANDARDS FOR ACCOUNTANTS & APPRAISERS

AS A BANKING REGULATOR, I GREATLY ENVIED THE FHLB SYSTEM FOR HAVING REGULATIONS REQUIRING CERTIFIED ANNUAL AUDITS OF THE INSTITUTIONS AND CURRENT APPRAISALS OF REAL ESTATE LOANS. UNFORTUNATELY, THE REGULATIONS DID NOT NECESSARILY PRODUCE VALID RESULTS FROM AUDITORS AND APPRAISERS. I KNOW NUMEROUS CONGRESSIONAL HEARINGS HAVE BEEN CONDUCTED ON THE PERFORMANCE OF AUDITORS AND APPRAISERS AND ANY RECOMMENDATIONS THAT I MIGHT HAVE WOULD ONLY REAFFIRM THE NECESSITY FOR IMPROVED STANDARDS, QUALITY, AND CULPABILITY. THE ONE SPECIFIC AREA I WOULD EMPHASIZE WOULD BE THAT ADDITIONAL RESPONSIBILITY NEEDS TO BE GIVEN TO THE ACCOUNTING FIRMS TO REQUIRE THAT THEY CERTIFY IN THEIR ANNUAL AUDITS AS TO THE ADEQUACY OF INTERNAL SYSTEMS AND CONTROLS WITHIN THE FINANCIAL INSTITUTION.

PROTECTION OF THE INTEGRITY OF SUPERVISION

AS I STATED EARLIER IN MY TESTIMONY, 1986 AND 1987 WERE TIMES OF INORDINATE PRESSURE ON THE SUPERVISORY PROCESS IN TEXAS. PART OF THAT PRESSURE WAS POLITICAL IN NATURE AND UNNECESSARILY DELAYED THE INITIATION OF PROMPT ACTION AND CONTRIBUTED TO ADDITIONAL ULTIMATE COSTS TO FSLIC. MY EXPERIENCE AT THE OCC WAS THAT MEMBERS OF CONGRESS VERY CAREFULLY AVOIDED CONFLICTS WITH THE REGULATORY PROCESS IN ANSWERING CONCERNS OF CONSTITUENTS. TO THE CONTRARY IN THE THRIFT INDUSTRY, SPECIFIC ACTIONS WERE REQUESTED WITHOUT THE BASIS OF ACCURATE OR RELIABLE INFORMATION. IT HAS BEEN SUGGESTED THAT INTERFERENCE WITH THE REGULATORY PROCESS BY MEMBERS OF THE CONGRESS OR THE EXECUTIVE BRANCH BE EXPRESSLY FORBIDDEN BY LAW. MY RECOMMENDATION IS ONLY A GENERALIZATION IN THAT THE INTEGRITY OF THE REGULATORY PROCESS MUST BE PROTECTED AT ALL COSTS FROM INAPPROPRIATE INTERFERENCE AND INFLUENCE, REGARDLESS OF THE SOURCE. AND I CERTAINLY BELIEVE THE INDEPENDENCE OF THE REGULATORY PROCESS SHOULD CONTINUE TO BE SUPPORTED BY APPROPRIATE CONGRESSIONAL OVERSIGHT TO INSURE ITS EFFECTIVENESS AND FAIRNESS.

ETHICS AND STANDARDS OF CONDUCT

BOTH COMMERCIAL BANKS AND THRIFTS HAVE A MAJOR RESPONSIBILITY FOR THE PERFORMANCE AND ACTIVITIES OF THEIR MEMBERS. IT MUST BY NECESSITY INCLUDE STRONG SELF ENDORSED AND SELF ENFORCED CODES OF ETHICAL PRACTICES AND CONDUCT. THE LACK OF ETHICS AMONG A LARGE SEGMENT OF THE THRIFT INDUSTRY IN THE SOUTHWEST IN MY OPINION WAS APPALLING. IT WAS ALSO UNCONSCIONABLE THAT THE GOOD SEGMENT OF THE INDUSTRY WATCHED THE UNETHICAL BEHAVIOR OF THE MINORITY AND TOOK LITTLE IF ANY ACTION TO BLOW THE WHISTLE. SELF IMPOSED INDUSTRY STANDARDS OF ETHICAL PRACTICES AND CONDUCT WILL DO MUCH TO ALLEVIATE THE SPECTRE OF CONGRESSIONALLY MANDATED STATUTES ON ETHICS.

THE DIRECTORS OF FINANCIAL INSTITUTIONS ALL TOO OFTEN FAIL TO EXERCISE THEIR FIDUCIARY DUTIES AND RESPONSIBILITIES. THIS FAILURE CAN BE ATTRIBUTED TO A VARIETY OF THINGS, BUT PRINCIPALLY TO INATTENTION TO THE ACTIVITIES OF INSTITUTIONAL MANAGEMENT AND TO A LACK OF CLEAR UNDERSTANDING OF THEIR DUTIES, RESPONSIBILITIES AND LIABILITIES AS DIRECTORS. THE OCC HAS RECENTLY ISSUED A BOOKLET TO ASSIST DIRECTORS IN UNDERSTANDING THEIR FIDUCIARY ROLES. THE FHLBB COULD LIKEWISE CONTRIBUTE TO A BETTER UNDERSTANDING BY STRUCTURING A FORMAL EDUCATIONAL PROGRAM FOR DIRECTORS WITHIN THE BANK BOARD SYSTEM. IN ADDITION, I HAVE ALWAYS BELIEVED THAT PENALTIES PRESCRIBED BY LAW, IF PURSUED AGAINST INTENTIONAL AND FLAGRANT ABUSE OF DIRECTORS' RESPONSIBILITIES, WILL HAVE A SALUTARY EFFECT ON SUCH ACTIONS IN THE FUTURE.

CLARIFICATION OF CHANGE OF CONTROL

IDEALLY A GOOD CRYSTAL BALL SHOULD BE THE BEST POSSIBLE COMPONENT OF A GOOD CHANGE OF CONTROL PROCESS. SHORT OF THAT, I WOULD FAVOR A STATUTE THAT GAVE REGULATORS WIDER LATITUDE IN DENYING ENTRY TO THE INSURANCE-PROTECTED FINANCIAL SERVICES INDUSTRY. WHILE I DO NOT ADVOCATE HIGHLY RESTRICTED ENTRY, I DO THINK IT NEEDS TO BE VIEWED AS A PRIVILEGE AND NOT AS A RIGHT. IN THIS CONTEXT, THE BURDEN OF PROOF OF QUALIFICATIONS SHOULD BE ON THE APPLICANT AND NOT ON THE REGULATOR.

TRAINING IN FRAUD & WHITE COLLAR CRIME

I HAVE BEEN A LONG STANDING ADVOCATE OF COMPREHENSIVE AND CONTINUING TECHNICAL TRAINING FOR BANKING AND THRIFT REGULATORS. AND I THOROUGHLY SUPPORT THE RECENT EFFORTS OF THE FHLB SYSTEM TO IMPROVE THE CONSISTENCY AND QUALITY OF THEIR TRAINING. AS THE FINANCIAL MARKETPLACE INNOVATES AND DEVELOPS, IT IS IMPERATIVE THAT ITS SUPERVISORS HAVE THE APPROPRIATE KNOWLEDGE AND TOOLS TO DO THEIR JOB EFFECTIVELY. SPECIALIZED TRAINING IN THE DETECTION OF FRAUD AND WHITE COLLAR CRIME IS AN APPROPRIATE AND NECESSARY PART OF THAT TRAINING CURRICULUM AND IT SHOULD BE PROVIDED EARLY ON IN THE CAREER OF EACH SUPERVISOR. WHILE TRAINING IS NOT A SUBSTITUTE FOR EXPERIENCE, I DO BELIEVE THAT THE RIGHT TRAINING CAN INCREASE THE LIKELIHOOD OF THE RIGHT QUESTIONS BEING ASKED AND, THUS, INCREASE THE LIKELIHOOD OF EARLY ATTENTION TO DEVELOPING PROBLEMS.

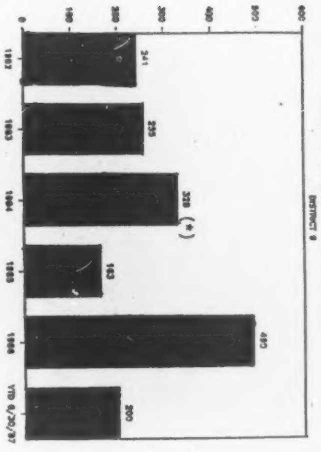
V. CONCLUSION

THERE ARE MANY VIABLE STEPS THAT CAN BE TAKEN TO DETER ABUSIVE CONDUCT AND FRAUD AND I CERTAINLY CONSIDER THE MAINTENANCE OF A STRONG SUPERVISORY STRUCTURE TO BE THE KEYSTONE. IT WOULD BE DIFFICULT TO DETERMINE OR ESTIMATE THE PORTION OF THE ULTIMATE COST TO THE INSURANCE FUNDS ATTRIBUTABLE TO FRAUD. BUT THE FIGURE UNDOUBTEDLY WOULD BE IN THE HIGHEST PERCENTILE, PERHAPS EXCEEDING 50%, AND WOULD ENCOMPASS A LIKE PERCENTAGE OF THE INSOLVENT INSTITUTIONS IN THE SOUTHWEST.

I AM PROUD THAT I HAVE SPENT THE GREATER PART OF MY LIFE IN THE FINANCIAL SERVICES INDUSTRY. COMMERCIAL BANKS AND THRIFTS HAVE PLAYED AN IMPORTANT PART IN SERVING THE PUBLIC INTEREST. WHILE WE ARE FACING AN UNPRECEDENTED CRISIS IN OUR FINANCIAL SYSTEM, I CONTINUE TO BELIEVE THAT THE MISTAKES OF YESTERDAY CAN BE TURNED INTO THE SOLUTIONS OF TOMORROW.

I WILL BE PLEASED TO TRY AND ANSWER ANY QUESTIONS THAT MEMBERS OF THE COMMITTEE MAY HAVE OF ME AT THIS TIME.

EXAMINATIONS COMMENCED



(*) 1984 examinations in large part consisted of 1-day visitations.

Source: Federal Home Loan Bank of Dallas

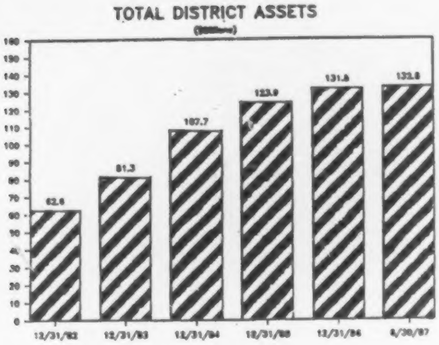
STATISTICS ON CRIMINAL REFERRALS

	1986	1987
Ninth District Institutions:		
Texas	419	959
Arkansas	21	39
Louisiana	29	64
Mississippi	41	71
New Mexico	25	63
TOTAL	535	1,196

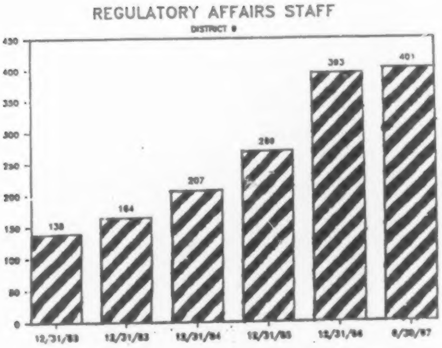
ENFORCEMENT ACTION SUMMARY

Type	1985	1986	1987	1988
407(M)	1	9	15	4
Cease and Desist Order	1	20	12	2
Commitment Letter	0	2	16	4
Consent/Merger Agreement	15	34	58	49
Directors Resolution	17	16	2	2
Removal and Prohibition	1	4	9	4
Supervisory Agreement	43	60	14	12
Other	6	5	4	7
TOTAL	85	150	130	84

Source: Federal Home Loan Bank of Dallas



Source: Federal Home Loan Bank of Dallas



SPECIAL INVESTIGATIONS

Special Investigations coordinates the Bank's supervisory activities when possible criminal violations involving an insured institution are indicated. It ensures that criminal referrals are properly prepared and transmitted to the appropriate enforcement and prosecutorial agencies. It arranges the production of documents in response to Grand Jury Subpoenas and Agency requests. It obtains, prepares, analyzes and transmits information relative to possible criminal violations and provides status reports on individual cases to the various responsible operating Supervisory Agents and the FHLBB staff.

The Unit will coordinate the Bank's interface and involvement with the taskforce investigating the thrift industry in North Texas and will be responsible for scheduling Bank staff to offer both oral and document information to the taskforce. The Unit maintains an up-to-date data base of information extracted from criminal referrals prepared by insured institutions and Bank Examiners from 1982 through the present. Unit staff presents information about the Bank Board and Dallas Bank upon request by criminal justice system agency personnel to foster an understanding of the Bank regulatory system. Unit staff stand ready to offer suggestions and assistance in preparing criminal referrals for submission to the investigative and prosecutorial authorities and encourages all Regulatory Affairs personnel to be alert for suspected criminal activity.

Source: Division of Regulatory Affairs
Federal Home Loan Bank of Dallas

SECTION-BY-SECTION ANALYSIS

TITLE - ENFORCEMENT

Section 101. Section 101 provides that this title may be cited as the "Savings Institutions Supervisory Amendments of 1987."

Section 102. This section amends all references in the FSLIC's enforcement authority that presently relate to officers, director, employees and agents, to replace them with the phrase "institution-related party", which covers a wider range of individuals including a person who has filed or is required to file a notice under the Change in Savings and Loan Control Act. This new term is defined in Section 117.

Section 103. This section makes parallel amendments to those in Section 102 regarding the Bank Board's authority over federally chartered institutions contained in the Home Owners' Loan Act and substitutes the new phrase "association-related party", as defined in Section 118.

Section 104. This section amends the National Housing Act to address a problem caused by a court decision against the Office of the Comptroller of the Currency in Larimore v. Conover, 789 F.2d 1244 (7th Cir. 1986). It allows the FSLIC to order restitution or reimbursement from their institution-related parties to recover losses resulting from violations of law or other improper conduct. The Larimore decision determined that reimbursement was not a remedy available to the Office of the Comptroller of the Currency in an administrative cease-and-desist proceeding under its parallel statute.

This section also allows the FSLIC to use a cease-and-desist order to limit the activities or functions of an institution-related individual or insured institution, thus enabling the FSLIC to prevent specific practices or conduct by thrift officials where the circumstances may not be serious enough to warrant issuance of an order of removal or prohibition under Section 407(g).

Section 105. This section makes amendments regarding the Bank Board's authority in the Home Owners' Loan Act that are parallel to those in Section 104.

Section 106. This section clarifies that the agency's enforcement authority under the National Housing Act and the Home Owners' Loan Act reaches all service corporations, including second-tier and partly owned service corporations of federal associations and insured institutions.

Section 107. This section clarifies that a temporary cease-and-desist order may place limits on the activities or functions of an institution-related party or insured institution, similar to those set out in section 104 above. It also expands the FSLIC's authority to issue a temporary cease-and-desist order to halt an institution's business activities when the FSLIC is unable to determine the financial condition of such institution or the nature of any transaction because of the disarray or lack of adequate books and records at the institution.

Section 108. This section makes the same amendments to the Board's authority to issue temporary cease-and-desist orders against federal associations and association-related parties as does section 107 for insured institutions.

Section 109. This section provides that if an institution-related party is removed, suspended, or prohibited from an insured institution, service corporation or subsidiary, or a savings and loan holding company or subsidiary, he is also removed, suspended, or prohibited from all federally insured depository institutions, all bank holding companies, and institutions chartered under the Farm Credit Act of 1971 (unless he is allowed to return by the appropriate Federal regulatory agency, as defined in the Federal Deposit Insurance Act). No longer is it necessary for the Corporation to initiate a separate enforcement proceeding in order to remove from an FSLIC-insured institution or savings and loan holding company a person whom the OCC, FDIC, Federal Reserve Board, NCUA, or Farm Credit Administration has already removed from a national or state bank, a bank holding company, a credit union, or an institution chartered under the Farm Credit Act of 1971.

The section also provides than an institution-related individual may be removed or prohibited based on unsafe or unsound conduct causing financial loss or other damage to an insured institution or another business institution. In addition, paragraph (1) of amended section 407(g), which sets out the three grounds required for initiation of a removal action, is broken into subparagraphs to make it easier to understand. Furthermore, former paragraph (1), which applied to any director or officer of an insured institution with respect to his conduct regarding that institution, and former paragraph (2), which applied to such individual's conduct with respect to another insured institution or business entity, have been combined so that paragraph (1) now applies with respect to the individual's conduct regarding any insured institution or other business institution, as defined in the National Housing Act. Former paragraph (5) of section 407(g) is revised to use the terms "notice" and "order" consistently throughout the section.

Section 110. This section makes amendments to the Bank Board's authority under the Home Owners' Loan Act to remove or prohibit individuals from financial institutions, which amendments are parallel to those made by Section 109 with respect to the National Housing Act.

Section 111. This section is a technical amendment to conform to the renumbering of certain paragraphs in Sections 109 and 110.

Section 112. This section clarifies the FSLIC's authority to pursue sanctions, including removal, against an institution-related individual despite his resignation or other separation from an institution. This will prevent such an individual from trying to thwart a removal action by resigning. It also redesignates the paragraph numbers in paragraph (k) of Section 407 in order to conform with other changes made in the bill.

This section also amends the provisions of the National Housing Act to provide the FSLIC with the same authority to impose monetary penalties for violations of law or regulation that the Comptroller of the Currency has long held.

Section 113. This section makes amendments with respect to the Board's removal and prohibition powers under the Home Owners' Loan Act that are parallel to those made in section 112 for the National Housing Act.

Section 114. The first sentence of paragraph 1 of section 407(p) makes technical amendments in accordance with changes made in section 109. It also clarifies that only with the prior written approval of the appropriate federal banking agency may an individual who is the subject of a removal, prohibition a suspension order under Section 407 of the National Housing Act, become an officer or participate in the affairs of another depository institution or holding company. The second sentence of this section would make it clear that the FSLIC, when issuing a suspension, removal or prohibition order, has authority to prohibit any of the acts that would be illegal under subsection (g) of section 407.

The second paragraph of this section changes the existing standard of proof for proceedings against individuals (who have been convicted of criminal offenses involving dishonesty or breach of trust and who violate the prohibition against participation in the conduct of the affairs of insured institutions) from a "willful" to a "knowing" violation. It prohibits such individuals from participating in the conduct of the affairs of an insured institution and would increase the penalty from $100 per day to $1,000 per day for any violation, which penalty could be imposed against individuals or insured institutions.

Section 115. This section makes amendments with respect to the Home Owners' Loan Act that are parallel to those in section 114.

Section 116. This section conforms the FSLIC's civil money penalty authority under the Change in Savings and Loan Control Act (12 U.S.C. § 1730(q)), to the same procedure applicable to other civil money penalty authority of the FSLIC. This means that such penalties may be assessed following a hearing before the agency conducted pursuant to the Administrative Procedure Act instead of the prior requirement for an abbreviated agency procedure, followed by de novo review in a U.S. district court.

This section also eliminates the requirement that the FSLIC demonstrate that a violation of the Change in Savings and Loan Control Act is "willful" in order to assess a civil money penalty, thus conforming this Act to other banking law provisions which provide for civil money penalties.

Section 117. This section revises the definitional subsection (r) as follows:

Paragraph (1) clarifies the definition of "cease-and-desist order that has become final" and "order which has become final." Paragraph (2) adds a definition of "institution-related party", as discussed in the comment on proposed section 102 above, while incorporating pertinent language from a former definition in Section 407(r)(4). Paragraph (3) eliminates any implication that "or" means "one or the other but not both", making it unnecessary to substitute "and/or" for "or." Paragraph (4) defines the term "insured institution" for enforcement purposes to include institutions whose insured status is terminated and Federal savings banks the deposits of which are insured by the Federal Deposit Insurance Corporation.

Section 118. This section makes amendments with respect to the Home Owners' Loan Act that are parallel to those in Section 117, except that the expanded definition of "association" is added by Section 119, and that language defining the terms officer, director, employee and agent has been transferred from Section 5(d)(14) of the HOLA to the definition of "association-related party" in Section 5(d)(13).

Section 119. This section makes amendments to the definitions contained in the Home Owners' Loan Act that parallels those made in paragraph (4) of Section 117.

Section 120. This section creates a new paragraph (u) of Section 407 of the National Housing Act that requires insured institutions and Federal savings banks to make reports of condition to the FSLIC, and subjects those that either fail to furnish such information or furnish false or misleading information to the assessment of civil penalties. These powers, except for assessment of penalties for submission or a false or misleading information for which statutory authority is now being sought, are the same as those already held by the OCC, the FDIC, and the Federal Reserve Board.

Section 121. This section makes it clear that the enforcement authority granted in section 407 of the National Housing Act is in addition to, and not limited by, any other statutory grant of authority, as provided by either Federal or State law.

Section 122. This section makes amendments to the Home Owners' Loan Act that parrallel those made in Section 121.

Section 123. This section deletes paragraph (15) of Section 5(d), which is incorporated in Section 5(d)(13) by Section 119 of this Act, and redesignates paragraph (16) as paragraph (15).

Section 124. This section amends the provisions applicable to savings and loan holding companies to make the requirements for reports of condition parallel to those provided by Section 120.

Section 125. This section deletes the requirement under the Bank Protection Act that financial institutions have to submit periodic reports to the Federal supervisory agencies with respect to the installation, maintenance and operation of security devices and procedures. The Act continues to require compliance with the agencies' rules establishing minimum standards with respect to these matters.

Sections 126 and 127. These sections clarify the Right to Financial Privacy Act's existing exemption for supervisory agencies, found in section 1113(b) of that Act.

The amendment made by this section would clarify that a supervisory agency with statutory authority to examine the records of a financial institution is exempt from pertinent restrictions in the Act where the agency is exercising its supervisory, regulatory or monetary functions with respect to that financial institution or any financial institution, holding company, or a subsidiary of the institution or holding company or any officer, director, employee or other person participating in the affairs thereof. The amendment would also clarify than an agency is pursuing such a supervisory function where it is exercising its authority with respect to the officers, directors and employees of the institutions they supervise.

Section 128. This section amends the Right to Financial Privacy Act to allow financial institutions and supervisory agencies to provide financial records to another agency or department of the

United States if there is reason to believe the records are relevant to a possible violation of criminal law against the institution or agency or a possible violation of the Controlled Substances Act, the Controlled Substances Import and Export Act, the Bank Secrecy Act, or the Maritime Drug Law Enforcement Act.

Section 129. This section amends the Right to Financial Privacy Act to provide a limited exemption for agencies of the United States to transfer records properly obtained to another Federal agency or department if there is reason to believe the records are relevant to a matter within the jurisdiction of the receiving agency.

SIGNIFICANT ACCOMPLISHMENTS BY FHLBB IN COMBATTING FRAUD AND INSIDER ABUSE

A. Helping to establish and actively participating in the Interagency Bank Fraud Working Group composed of banking regulators, the Department of Justice (DOJ) (comprised of senior representatives of the Criminal Division Fraud Section, the FBI and a U.S. Attorney) in which problems related to criminal investigations and prosecutions are discussed and resolved and policies to increase interagency cooperation are set. This group has been a major force in developing an improved and comprehensive response to bank fraud.

B. Promulgating a regulatory requirement that all institutions insured by the FSLIC and their subsidiaries make criminal referrals to the FBI and DOJ.

C. Formation of special investigative or criminal referral units (i.e., where one or more individuals performs tasks in these areas as the major part of their assigned duties) at 9 Federal Home Loan Banks that provide assistance to the FBI and the Department of Justice by furnishing information, providing expert and factual witnesses, and following up on criminal referrals. (The remaining 3 FHLBanks have (an) individual(s) assigned to perform this function, though it occupies less of their time.) A strong trend is indicated by the fact that when the Subcommittee requested information about this function last year, there were only 3 such units.

D. Development and continuing improvement of the Bank Board's Confidential Individual Information System, which contains in one place information on inter alia, criminal referrals and civil enforcement actions against individuals and which is available to other banking regulators and the DOJ.

E. The ongoing formation of 16 local bank fraud working groups, based on the national group model. Only 3 such groups existed in 1987. The Federal Home Loan Banks and the Board are or will be active participants in nearly all such groups.

F. Setting up meetings between Bank Board staff, United States Attorneys' Offices and the Fraud Section of DOJ to resolve specific problems related to investigation and prosecution of financial institution crime and to offer our assistance.

G. Developing examiner training and furnishing speakers for courses in the detection of white collar crime put on by the FBI and the Federal Financial Institutions Examination Council, which are available to all bank examiners. In addition, several Federal Home Loan Banks are developing such courses to serve the needs of local examination staff.

H. Participation in two major bank fraud task forces in Texas, known as "Thriftcon" and "Texcon." The Thriftcon Task Force, which has resulted in 23 indictments and 13 convictions to date, has been aided by the designation of three Bank Board and FHLBank employees as agents of the grand jury or special assistant U.S. Attorneys. These arrangements allow more direct assistance by agency personnel and give the investigator or prosecutor substantial benefit of agency expertise.

I. Aiding the Texcon Task Force by the furnishing of information and examiner expertise. This Task Force has resulted in 103 convictions arising from fraud in connection with loans made on properties in the Dallas I-30 corridor.

J. Revision of the criminal referral form after extensive consultation with the FBI and DOJ, in order to present them with the information critical to the making of investigative and prosecutorial decisions.

K. Increasing the number of civil enforcement actions against individuals in response to the Subcommittee's recommendation from 25 in 1983 (the year of the last previous data requested by the Subcommittee) to 59 in 1987, a 136 percent increase. Formal enforcement orders undertaken by the Bank Board against individuals continued at about the same level in 1988 as they did in 1987, despite the significant reduction in the number of problem institutions that were not under some form of supervisory control during that period of time.

L. An increase in enforcement actions against individuals from 50 in 1983 to 132 in 1987, a 164 percent increase. By means of the active enforcement posture of the Board as shown in K and L, we have made great strides to controlling the problems of the industry.

M. Increasing the staff of the Board's Office of Enforcement from 11 in 1983 to 58 currently. In January 1989 10 additional positions were authorized for that Office.

N. Meetings of criminal referral coordinators at all Federal Home Loan Banks every six months, to exchange information and compare strategies in facilitating bank fraud prosecution.

O. Committing 30 staff members of the Bank Board and Federal Home Loan Banks throughout the country to serve as agents of the grand jury or as special assistant U.S. Attorneys in order to facilitate investigation and prosecution.

P. Providing training in the operations of savings and loans and the financial regulatory system to U.S. Attorneys and their staff.

Q. Preparation of a manual regarding sources of information and operation of the regulatory system to be disseminated to all U.S. Attorneys for the quick reference of their staff.

R. Securing restitution of funds lost to the FSLIC as part of criminal sentences under the Victim and Witness Protection Act. While this is a fairly recent initiative of the Board, courts have already ordered criminal defendants in S&L cases to pay in excess of $50 million in restitution or fines.

S. An increase in the number of criminal referrals involving crimes against savings and loans from 434 in 1985 to over 6100 in 1988.

T. Circulation of the names of an FBI/DOJ contact person in every Federal Home Loan Bank to all FBI and U.S. Attorneys Offices. The contact's role is to resolve problems and serve as a conduit for information to the investigator or prosecutor, particularly when the investigator or prosecutor is uncertain of whom to contact.

U. Directing fee counsel, who are employed by the FSLIC to use civil means to recover losses to the FSLIC, and advising them that, in cases of conflict, the Board's interest in aiding criminal prosecution takes precedence over the civil recovery actions. Similarly the obligation to make criminal referrals based on facts discovered by fee counsel has been placed in the FSLIC's standard contract with fee counsel.

V. Promulgation of a regulation designed to prevent the fraudulent sale of loans or of participation interests in loans by requiring that the purchaser obtain the basic underwriting documentation needed for the purchaser to determine the quality of the loans.

W. Requiring audit reports of institutions to be provided to the Board and making examination reports available to auditors of insured institutions. These actions further the ability of both the examiner and the independent auditor to uncover violations of regulation and fraud.

X. Publishing guidelines encouraging institutions to adopt and require employee compliance with codes of conduct designed to prevent the corrupt acceptance of benefits by officers, directors, or personnel of insured institutions from those with whom the institution does business.

Y. Drafting of enforcement legislation designed to enhance our ability to pursue individuals who cause loss to savings and loans and to remove statutory impediments to providing information about suspected crimes to the FBI and DOJ. While the proposed enforcement legislation was passed by the Senate in 1988, the House did not act on it. However, the Board and other banking agencies did obtain a badly needed amendment to the Right to Financial Privacy Act that removed impediments to the transfer of information concerning suspected crimes.

Z. Expediting internal procedures to make it possible to quickly supply Board information in response to a subpoena served on a Federal Home Loan Bank.

AA. Through its Federal Home Loan Banks, hiring or negotiating to hire attorneys to serve as prosecutors in several U.S. Attorney's Offices.

The CHAIRMAN. Mr. Gleeson, we ought to turn to you and let you give us your testimony.

STATEMENT OF DAVID W. GLEESON, PRESIDENT, LINCOLN ASSET MANAGEMENT CO., DALLAS, TX

Mr. GLEESON. Thank you, Mr. Chairman.

I would like to have my written testimony made part of the record.

The CHAIRMAN. It will be.

Mr. GLEESON. It's an honor to have the opportunity to appear before you and your esteemed colleagues and other interested parties who have taken a sincere interest in the financial crisis that we are experiencing in the Southwest.

It's been made clear by previous testimony that fraud has played an important role and has been a key factor in the horrendous losses that have been uncovered in the Texas S&L's.

I'm going to differentiate a little bit and my application and use of fraud is what I call indictable fraud because there are many activities that probably under the current system may not be considered indictable but are clearly conflicts of interest or errors of judgment.

There are three other contributing factors that I think as far as trying to quantify losses are equally as important. Imprudent decisions are certainly a key role. It's hard to comprehend the euphoria in the marketplace in Texas in the early and mid-1980's. It was much like the stock market was prior to October 19, 1987. Everybody was doing it. Everybody was making money. Everybody was borrowing money from banks and S&L's and speculating in land. Oil prices, even though they had started their demise, people in the real estate industry did not correctly assess soon enough the ultimate impact of the oil price drops.

There was a failure in 1986 to really acknowledge the seriousness of the problem. Some of you through your questions to Mr. Selby alluded to that—well, why didn't some of these issues come out sooner? Then there were also very, very serious conflicts of interest where people were doing things with S&L's, either shareholders, directors, managers of S&L's, that you clearly couldn't do in a bank but there seemed to be some confusion as to whether or not those were permitted transactions within a savings and loan association.

SWIFT JUSTICE NEEDED

In Texas we much prefer to have you focus on what we think is the relatively nominal cost of swift indictments of the culprits. Justice in Texas used to be much quicker and much cheaper than it is today.

The CHAIRMAN. I saw a little of that on "Lonesome Dove" the other night.

Mr. GLEESON. Mr. Chairman, that's what reminded me of it. It was rather emotional when Robert Duvall hung one of his friends for crossing the line and that's what we'd like to see done with some of our friends down there.

President Bush has suggested that you consider allocating $50 million for pursuit of the criminal indictments. If you will keep in mind that the *Empire Savings* case which has now just gone to trial this week, 5 years after Empire Savings was put into receivership, those parties are accused of siphoning off and pilfering almost $100 million out of Empire Savings. They've got enough money to buy their own law firm and a downtown skyscraper to house them in.

We in Texas, the honest, hard-working professionals in the commercial real estate and financial services industry—and that's most of the people in those industries—would like to encourage you to consider doubling that amount and opening up the coffers and consider separate legislation to expedite the funding and application of those laws.

The greatest crime of all would be if the statute of limitations were permitted to run without the indictments having been filed. We think you ought to make it sure and I think the Attorney General did make it clear that they have the situation in hand. They've got a very effective strike force. Everybody has got clear lines of responsibility and we would certainly like to ensure that that is the case.

The Federal Home Loan Bank Board I think most of us feel comfortable—the Bank Board District in Dallas has done an exemplary job of eradicating the adverse elements out of the S&L industry. All of us have known for some time who the scoundrels are. Certainly the people in the Attorney General's office know who they are and what they did and how they did it and we hope that some of the people that apparently had some confusion here on Capitol Hill about who the culprits and scoundrels are have figured that out.

The evidence is there. We've been through the files. What they are going to need is simply manpower and money and time—and time is running out—to bring these people to justice and we down there commit to you, if you provide the funding for the indictments and the trials, we will bring the rope.

But please keep in mind as you conduct the postmortem on the S&L's and FSLIC and the fraud that losses were just as much a product of the failure of the entire system and not just fraud. What in many cases started as aggressive lending by people lacking the expertise and the qualifications to make very complex, complicated, large commercial real estate transactions eventually became imprudent and abusive and then became reckless and irresponsible, and finally evolved into just outright fraud. Much of that fraud, in hindsight, was probably attempts to simply cover up previous mistakes and imprudent judgments.

Even Congress I think might have been part of the coverup. I read a quote in a old newspaper article back in 1987 in April from veteran Texas Congressman Chairman of the House Banking Committee, Henry Gonzalez, during the FSLIC recap hearings who was quoted as saying, "All I can remember doing on this committee is listening to and doing what the S&L industry wanted us to do and look where it's gotten us." I think they, too, can be considered part of the problem.

What were some of the key components in this formula for disaster? Well, my comments are not any specific indictments against any profession or generalizations about any elements of this chain, but simply about the entire system and also the people in positions of responsibility and accountability who failed to stand up and say, "Wait a minute. This is enough. We've gone too far. This is abusive. This is reckless. Let's get a handle on it."

Ed Gray, Roy Green, Joe Selby, Walter Falk were a few who did stand up early, raised the red flag, raised the issues, and the industry and some people here on Capitol Hill made it look like they were the problem. Fortunately, in hindsight, the record is being made straight.

DEREGULATION NOT UNREGULATION

One other thing. People apparently thought when Congress deregulated the S&L industry that they unregulated the industry, and I think in any new legislation you need to make it very clear what you mean by deregulation.

Where were the Federal regulators and the Federal examiners when all of this was going on? Well, part of the problem in the early stages was, as you've discussed earlier, there were budgeting problems. People were underpaid. They were inexperienced. They were here in Washington instead of out in the field in the regional banks.

And where were the State examiners? Well, the assets of S&L's in the State of Texas in 1982 were approximately $42 billion. In 1986, they had swelled to almost $100 billion, a 250-percent increase in that short period of time. The State examiners themselves were ill-equipped and unprepared for that kind of growth and the complex transactions that most of the S&L's became involved in and most of that additional money went into commercial real estate transactions.

Where were the independent auditors? Many of them it seems to us in what we looked at were applying their creative juices to the application of already liberal RAP accounting and in some cases were part of the problem in the big coverup.

RAP accounting was to be applied in reconciling some of the problems in the negative spread and the single family portfolios, and what happened was, it was used to create and then to cover up very complex commercial real estate transactions.

Where were the appraisers' standards of practice and ethics? Well, when S&L's were permitted to loan 100 percent of appraised value with total disregard to the actual cost of the property, the professional discipline of appraisers was challenged to the limit.

And accounting standards. There was tremendous confusion over what was a loan and what was a direct investment and what was a joint venture. There was confusion over what could be booked as immediate earnings and what should be capitalized.

Of course, anything booked as immediate earnings could be dividended out to the shareholders. And the owners—I made reference to the conflicts of interest. Bankers wouldn't dream of doing the things that many of these S&L owners and directors and management people became involved in. When you have a gentleman who is a major owner of an S&L who sits on the board, is not an officer of the S&L, and is actively involved in negotiating transactions in excess of $100 million for his institution, goes out and arranges financing with his institution for the acquisition of that transaction and turns around and negotiates for his own company a 15–20-year lucrative management development contract, it would appear that there is a bit of a conflict of interest in that instance.

[The complete prepared statement and executive summary of David W. Gleeson follows:]

EXECUTIVE SUMMARY

TESTIMONY BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS
ON
FRAUD IN THE S & L INDUSTRY
IN THE SOUTHWEST

FEBRUARY 9, 1989

PRESENTED BY
DAVID W. GLEESON, PRESIDENT
LINCOLN ASSET MANAGEMENT COMPANY
DALLAS, TEXAS

EXECUTIVE SUMMARY

The situation that exists in the S & L industry in the Ninth District of the Federal Home Loan Bank is evidence of a system that has experienced a total breakdown and failure. Even though there were conscientious people along the way who were warning of abuses and excesses, the majority of the participants were oblivious to their suggestions of impending peril.

The focus of this hearing is to determine the role and extent that fraudulent activities played in this debacle and how to prevent a recurrence in the future. Was fraud a major factor in creating these horrendous losses? Absolutely! But, there is an extremely fine line in many cases between fraud and imprudent decisions, poor judgment, reckless policies and inexperience.

These activities were certainly not limited to Texas, Louisiana, Arkansas and Oklahoma. Some of the biggest and worst cases of fraud, abuse and excess were in California and Florida. And, who knows what other problems have yet to surface --- and where? The problem is not confined to savings and loans. Banks have written off $45 billion in non-performing domestic loans in the past three years. 119 Texas banks were closed in 1988.

Who is really to blame? The entire system! I will attempt to show how every component broke down in this formula for disaster.

We all know the background of and reason for the deregulation of the thrift industry. What we got was unregulated deregulation. On April 1, 1987, the Dallas Times Herald quoted 26 year veteran Texas Congressman Henry B. Gonzales (now Chairman of the House Banking Committee) as saying "I can't remember this committee doing anything except what the industry wanted. And look where it got us." Savings and loans lobbied hard for the opportunity for uncontrolled and undisciplined growth and took it. The asset base of Texas S & L's grew from $42 billion in 1982 to just under $100 billion in 1986 ----- a 250% increase, or in excess of $12 billion per year. Most of that went into commercial real estate. That doesn't include the money that poured in from Arkansas, Louisiana and Oklahoma thrifts.

Let's start with one of the weakest links in the chain in the creation of the environment for fraud.

Deregulation permitted S & L's to make investments in areas that were completely foreign to their traditional home loan mortgage origination. Yet, they expected FHLB examiners to be able to examine and understand these complicated transactions. There was no provision for hiring more examiners or training them. Any new legislation and funding needs to provide pay scales and training for experienced examiners at the regional bank level.

Many of the biggest losses will be sustained in state chartered thrifts with FSLIC insurance. Where were the state examiners? They too were ill-prepared for this revolution. If state chartered thrifts want FSLIC insurance, then they should conform to all the rules, regulations, guidelines and policies of nationally chartered thrifts. Otherwise, you might consider making the state a co-insurer, requiring greater levels of equity capital, or lowering the ceiling on the amount of deposits covered. There is no point in having state and federal examiners conducting examinations confine that to the federal level.

Where were the independent auditors? Tremendous uncertainty existed within the thrift industry and accounting profession as to how to account for various points and fees. Should they be booked as lump sum immediate earnings, or capitalized? Is this transaction a loan or a joint venture? Does it qualify as a direct investment? Many of the auditors obviously did an extremely poor job of monitoring and reporting the activities of their clients. Strict auditing policies and procedures would have detected many early signs of questionable transactions. Files were incomplete, documentation was sloppy, and many fees were outlandish. Just the sheer volume of transactions created adequate suspicion. Accountants are accountable for determining the institutions safety and soundness for depositors, as well as for shareholders.

S & L's were permitted to make risky commercial real estate loans based on 100% of the cost, or appraised value, whichever is higher. I guess no one in the S & L industry was ever asked the question, "Do you know how to make a small fortune in real estate? Start out with a large one." Why should a $70,000 to $80,000 home loan require a 10-20% down payment while a $30,000,000 speculative land loan can be for 100% of cost (or more) plus all the interest carry. Clearly, the greatest abuses and most significant losses will be sustained in land deals. One of the recently merged Southwest Plan S & L's had funded $270 million into one land development project alone, which FSLIC now owns. A simple

change in the policy to require a loan for no more than 85-90% of cost and to require the borrower to service the interest payments out-of-pocket will eliminate the prospects for further reckless abuse in this area.

The career professionals in the appraisal industry are working diligently to generate legislation that will require the state certification of appraisers who want to do appraisals for federally insured institutions or on guaranteed loans. This is the same procedure as for accountants. There should be no "grandfathers" or exceptions to certification.

Liberal regulatory accounting practices (RAP) were permitted by the S & L industry in the early 80's as a means for them to ease the pain of accounting for their earnings and net worth deterioration caused by their single-family portfolios. RAP accounting was also used to hide the presence of commercial loan problems and proved to be of great benefit in shielding the extent of the problems. RAP accounting was another case of the industry writing their own policy manual.

Congress was warned that comprehensive sudden changes in the tax laws affecting real estate transactions would have very damaging and costly repercussions for financial institutions. I am not recommending going back to the old tax benefits for real estate, because they were certainly abused almost to the level of fraud. The favorable 1981 tax law changes were another increment in the chain that provided the illusion of legitimacy to many questionable deals.

Where were the Boards of Directors in detecting fraud and abuses? I guess nobody told them that they were personally liable for (1) assenting in or failure to prevent imprudent loans with inadequate security; (2) assenting in or failure to prevent loans based on false or fraudulent financial statements; (3) failure to establish good internal controls and audit procedures, (4) assenting in or failure to prevent waste, theft, or squandering of the institutions assets.

And, what about ownership? How did so many bad apples get in the barrel? And, why weren't there much stricter rules on self-dealing and conflicts-of-interest? How can a person be an officer and shareholder of an S & L one day, and the next day leave the institution to become a "developer", borrowing $50,000,000 from that institution to buy a piece of land?

Nobody knew how these complicated transactions all came together better than the attorneys preparing and reviewing the documents. Where was their judgment and their ethical standards of practice? How long will we let attorneys hide themselves behind the "attorney-client" confidentiality shields as an excuse while collecting fees on unethical and fraudulent transactions without having some culpability?

There seemed to be an evolution of lending practices starting out as being merely aggressive. What next became irresponsible, excessive and abuses turned into outright fraud as many became involved in the big cover-up. In the end, the extent of various levels of fraud was very pervasive.

The Justice Department will need lots of people and money to indict the culprits prior to the expiration of statutes of limitation.

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INTRODUCTION

Mr. Chairman, it is an honor to have this opportunity to appear before you and your esteemed colleagues, the press and other interested parties. Many people in Texas and the Southwest have been vitally concered about the extent of fraudulent activities and the lack of corresponding indictments. While most of us are convinced that the Bank Board has done an exemplary job of eradicating the marginal ownership out of the savings and loans, there is much concern that people who fraudulently pocket millions of dollars are still walking the streets. While the extent of fraudulent activities can probably never be quantified, please remember that Texas has consistently provided the thrift and banking trade groups with many of their most active advocates and respected leaders. That is still the case today.

My report covers three areas. First, is background information regarding my experience in commercial real estate. Second, is our our involvement in thrift real estate consulting for the Federal Home Loan Bank. Finally, I answer specific questions posed by the Banking Committee, which includes generic examples of fraudulent transactions.

SPEAKERS BACKGROUND

After obtaining my BBA Degree with a major in Banking and Finance from Southern Methodist University in 1965, I joined the Henry S. Miller Company in their sales training program. Except for a 6 month leave of absence for a tour in the U.S. Marine Corp Reserves, I continued with the Henry S. Miller Company for over 17 years. HSM Co. was the largest Texas based commercial real estate firm and the 3rd largest privately owned commercial real estate company in the country at the time of its acquisition by Grubb & Ellis in 1984. During my tenure with Miller, I started in shopping center leasing and site acquisition for various retail chains. In 1970, I organized and headed their Development Land Division specializing in marketing land to major Texas developers including home builders, apartment developers and office building developers. From mid-1975 to mid-1976, I was in charge of the Income Properties Marketing Division. During the summer of 1976, I relinquished all sales management responsibilities to specialize in the analysis and marketing of multi-family housing projects to major syndicators, substantial investors, and condo convertors. For the next 8 years I concentrated my efforts in the marketing of over $160 million of apartment projects and raw land.

In April 1984, I became a partner with Lincoln Property Company to head up their new multi-family housing acquisition efforts. Throughout the 1980's LPC has consistently been the largest apartment developer in the country. It is also recognized as a major commercial developer of office buildings, industrial properties and shopping centers. It was at this time that we anticipated opportunities to acquire distressed apartment projects from thrifts, banks and life insurance companies which would result from the excessive over-building. Little did we know at the time how extensive the debacle of the commercial real estate market in Texas and the Southwest would ultimately become.

I am currently Trustee for two Trusts to be funded by a major state employee's retirement system with up to $136 million for the purchase of apartments in the Southwest.

A PROBLEM PERCEIVED

It was not until we analyzed specific properties for acquisition that we began to grasp the extent and scope of the problem. At that time, most of these projects were still owned by the original developer or some limited partnership group. As an example, we would be submitted a property for our consideration that was priced at $12 million with $2 million of equity invested over and above a $10 million mortgage. Our analysis of the property determined a value of $9 million, which would not only result in the investor's equity being totally obliterated, but also would require a $1 million loss to the institution. Obviously, that early in the game, many property owners and all lenders thought we were being extremely cautions and pessimistic on the outlook for the market. Of course, at that time, we were competing against many highly tax-shelter oriented investment groups who analyzed apartment investment opportunities more for their tax shelter benefits than they did for pure economics of cash flow and appreciation.

Fortunately, in the next 18 months we only closed one deal that met our guidelines for sound economics. This included the review of over 250 properties in Houston alone. In addition, we considered deals in Chicago, Indianapolis, Indiana, North and South Carolina, Georgia, Florida and throughout Texas. In hindsight, our highly disciplined approach proved to be a prudent strategy. Even in the markets that did not end up over-built, the simple change in the 1986 tax laws had a horrendous effect on the pricing structure and market value of apartments. In those regions where over-building was coupled with the tax law changes, the results have been devastating.

We focused our efforts on trying to do acquisitions with savings and loans, and it became apparent that almost every apartment deal that we saw financed by a thrift was substantially over-leveraged. This was one of the major fallacies of permitting thrifts to finance commercial real estate based on 100% of appraisal, with a total disregard to actual cost. This practice became especially abusive in land deals.

As we analyzed more and more thrift financed apartments, we became alarmed at the extent of this problem. It was obvious that if all of these apartment projects were so tremendously over-financed, that the office buildings, shopping centers, and land deals surely suffered from the same excessive leverage.

In late 1985, we began asking ourselves how thrift managers, owners and, especially, the regulators could possibly continue to renew and extend these loans as their maturity dates came due. What was actually happening was that the thrift had included in the loan a huge interest reserve so that the borrower would simply draw down on the interest reserve portion of his loan to pay the S & L its interest. When the loan came due and the borrower couldn't sell the property or refinance it to pay off the thrift, the thrift simply added additional interest reserve for another 1 to 2 years and renewed the loan again. Thereby, they continued to compound the problem.

As we became more concerned about the extent of this phenomenon, we began to talk to S & L management, thrift accountants, S & L lawyers, bankers, and even some of the borrowers to begin to get a better handle on thrift accounting and lending procedures.

CONSULTING BEGINS

In January, 1986, I met with my partners and told them that I believed there was a major crisis in the Texas S & L industry and that I believed there would be an opportunity for LPC to lend its expertise in consulting services to the state and federal thrift regulators. As we began making contacts with the Texas S & L department and the Ninth District FHLB, we were made aware of their increasing concern as well.

In April of 1986, when the federal regulators placed one of the largest Dallas area thrifts under a Cease & Desist Order and a Supervisory Management Agreement, I contacted the Ninth District FHLB to offer our consulting assistance. We set up a meeting a couple of days later. We were advised that they would like to use our services in helping them to evaluate some of the commercial real estate deals in various thrifts that were of major concern to them. We originally were given four loans with a small East Texas thrift. After those reports were submitted, the flood gates opened and we ultimately reviewed over $5 billion in commercial real estate transactions for eight of the 25 largest savings in loans in Texas, as well as one each in Louisiana, Arkansas and Kansas.

We submitted virtually hundreds of written reports evaluating commercial real estate. Most of these ultimately were reviewed by federal and state supervisory agents.

THE CRISIS EVOLVES

An example of the shock that began to hit the regulators occurred when we met on December 7, 1986 with Joe Selby, Walter Faulk, a number of their staff members, and a new management team for one particular thrift. Earlier that year, the thrift auditors had given the S & L a clean audit and said that they had a net worth in excess of the required 3%. At the time, that institution had total assets of around $750 million. At our meeting we submitted a combined report with the new management team showing a negative net worth of $250 million. In other words, in a matter of few months, this institution had gone from a positive net worth of over $20 million to a negative net worth of about $250 million.

How could state examiners, federal examiners, independent auditors, appraisers, attorneys, management, shareholders and the Board of Directors have been so horribly uninformed, ill-advised, uncaring, and inexperienced to not have realized the condition of this institution in advance of our audit? This deterioration did not take place in 7 to 8 months.

Although some considered our assessments to be extremely conservative, if not pessimistic, the realities of the marketplace provided confirmation of our opinions. In December of 1988, when this institution became the leader in the merger and acquisition which resulted in Consolidated Federal Savings under the Southwest Plan, it's negative net worth had compounded to mroe than $300 million.

As more and more real estate consultants began to pour through the commercial real estate portfolios throughout the Ninth District, the Bank Board began to get a painfully realistic assessment of the condition of these thrifts. From the Spring of 1986 to the early Summer of 1987, the regulators received reports similar to our example on many of the larger thrifts in the Ninth District as well as on their much smaller counterparts.

INDUSTRY DENIAL

By the Summer of 1987, the political pressure from the Savings & Loan industry had taken its toll and the Bank Board apparently began to acquiesce to intense pressure by no longer insisting that real estate consultants be required to review assets under supervisory management agreements. By that time, the Bank Board had ample data on enough institutions to extrapolate their findings throughout the Ninth District and determine the severity of the problem. In spite of the extent of the problems disclosed by the numerous independent consultants, many elected officials were terribly misguided and misled by industry representatives who themselves did not understand the extent of the commercial- real estate problem. I served on a committee organized by the Texas Savings & Loan League that went to great lengths to detail every reason for the development of this situation, except for their own lending policies, practices and procedures.

Within a few short months, Bank Board Chairman, Ed Grey, Ninth District Bank President Roy Green, Executive Vice President for Supervision Joe Selby, and Senior Vice President for Supervision Walter Faulk, would depart from their respective positions. These men deserve considerable praise for uncovering and putting into perspective for the industry, the Congress, and the country what has turned out to be the biggest financial embarrassment in U.S. history.

The savings and loan industry had lobbied hard for passage of legislation that would provide them the opportunity to grow out of their negative spread problem in their single-family portfolios during those hyper-inflation times of the late 1970's. Congress created for them the unbridled freedom for growth without mandating or providing the requisite supervisory guidelines to assist them through the transition into totally new areas of lending and investing. In 1982, the asset base of Texas thrifts was $42 billion. At its peak in 1986, the asset base of Texas thrifts was $100 billion.

Was this massive fraud? Absolutely! At the very least, there was an enormous failure of individuals to exercise their fiduciary responsibilities as managers, Directors, auditors, appraisers and lawyers. The state and federal examiners can be forgiven to a degree because they were totally inexperienced and incapable of handling the level of responsibility intrusted to them. Managers, appraisers, auditors and directors had professional, moral, ethical and fiduciary responsibilities which they assumed in their various capacities.

The extent of irresponsible and questionable transactions was so pervasive, and (the use of) reckless lending policies, wildly aggressive appraisals, and ludicrous deals were so wide-spread that each new round of transactions enticed the perpetrators on to larger, more complex, and more (creative) deals with an ever-increasing disregard for sound economics and market demand.

SPECIFIC BANKING COMMITTEE QUESTIONS

1. - 3. How many assets of insolvent or problem thrifts in the Dallas area and throughout the Ninth District have you had occasion to examine and in what capacity?

Answer. Lincoln Asset Management Company, or LAMCO, as an independent real estate consultant approved by the Federal Home Loan Bank at Dallas, was retained by numerous thrifts as required in their supervisory management agreements. Under these various consulting engagement agreements, LAMCO reviewed over 500 loans, REO's (real estate owned), joint ventures and direct investments totalling over $5 billion in book value. We have also spent 16 months reviewing and analyzing the infamous I-30 condominiums from the Empire Savings of Mesquite Recoivership.

4. How many of the insolvent or problem thrifts you examined became so because of suspected or alleged fraudulent activity?

Answer. One important point to remember is that it was entirely possible under new powers granted by thrift deregulation for S & L management/owners (privately held stock thrifts) to generate hundreds of millions of dollars in new commercial loans which were all properly documented (with required appraisals in the files and accepted accounting standards applied) and resulted in millions of dollars in profits that were dividended out to the shareholders and have it be almost impossible to prove fraud. On the surface, they were simply doing what was permitted under deregulation. However, intent to commit fraud often was evidenced through the sheer volume of loans made to under-capitalized and inexperienced borrowers on ill-conceived projects with outrageous points and fees charged. The total asset base of Texas thrifts grew from $42 billion in 1982 to $100 billion in 1986, a 250% increase in 4 years. Loan volume and quick fee income were the primary business strategy. What started out merely as aggressive growth, led to imprudent lending fostered by greed and ended in fraudulent, questionable or irresponsible transactions in an attempt to cover up all of the bad deals. Although it is easy to assume that there must be extensive fraud in order for there to be such massive losses, it was more a total failure of the entire system which caused these losses.

Incomplete legislation in 1982 resulted in "un-regulated" deregulation and created a mandate for growth and an environment to seek new opportunities for profits. State and federal examiners clearly were not prepared for dealing with complex commercial real estate deals. Auditors and appraisers obviously took on assignments they did not have the skills, expertise or discipline to handle. Inexperienced boards of directors and loan committees approved deals that were incompetently and inadequately under-written. RAP accounting invited abuses and concealment of problems, and even when it became readily apparent that the Ninth District S & L's were in utter disarray, state and national thrift trade groups lobbied vigorously (and successfully) to deny the scope of the problems. Instead, they said that these problems were caused by the fraudulent activities of a few "bad apples" and a recession in the energy-based Southwest economy.

Certainly the collapse of oil prices had a damaging impact on the real estate market. I attribute one of the major reasons for the collapse in the commercial real estate market to the entrance of S & L's into the commercial lending arena. Prior to thrift deregulation, banks, life insurance companies, and pension funds dominated the commercial real estate lending market. Most of these institutions had built up experienced staffs of commercial loan underwriters and investment committees over many years in the business. As mentioned throughout this report, the asset base of Texas thrifts grew by almost $60 billion in 4 years. Most of that money went into commercial real estate as the thrift industry relinquished market shares of single-family loan originations for the more lucrative and larger commercial real estate transactions. Tax laws that were designed to encourage investments in plant and equipment in order for the U.S. industry to re-tool and update its aging plant and facilities became abusively applied to commercial real estate. This practice was the basis for luring billions of dollars of investor capital into marginal deals. Additionally, a continuation of the tax code policies which strongly encourage borrowing money, since the interest expense is deductible, has encouraged companies and individuals to gorge themselves with preposterous amounts of debt. For lenders to assume that the Texas and energy belt economies could continue their explosive growth of the late 1970's and early 1980's was extremely imprudent. How many times do we need to be reminded that the hotter a market gets in a boom the bigger the ultimate market correction will be? We have been reminded painfully of this in gold, silver, oil, real estate and stocks over the last few years.

5. What were the most prevalent types of suspected fraudulent activity in thrifts that took place in transactions you reviewed or were aware of in the market place?

Answer. Rather than try to limit my comments to transactions that certainly appeared to be fraudulent, I will expand them to include transactions that smacked of irresponsible and imprudent lending policies, unprofessionalism in appraisals, and abuses of permitted accounting standards. Although most of my references will be generic rather than references to specific institutions, they are based on actual transactions.

EXAMPLE A

Clearly the most notorious and abusive S & L case is that of Empire Savings of Mesquite. At the time of its being placed into Receivership in March of 1984, it had a total asset base of approximately $750 million. Almost their entire asset growth was generated by financing the development of thousands of condominiums in Garland and Mesquite in eastern Dallas County along Interstate 30. The Dallas real estate and financial services community watched in utter amazement as the parties to these activities were able to develop these projects with a total disregard for the market factors of supply and demand in a continuing series of transactions that were clearly questionable, even to the inexperienced observer. Now, five years later, after almost 1,000 of these units have been torn down or are fenced-in and uncompleted, over 600 units still sit vacant.

The basic format of this development program was for one of the parties to contract for the purchase of a piece of land, say 20 acres at $20,000 per acre. After obtaining the required zoning for the development of apartments/condominiums, the tract would be subdivided through a subdivision plat into ten 2 acre buildable sites. As utilities and streets were being installed, a series of land flips to dozens of small shell corporations generated a series of new loans, based on appraisals which substantiated an increase in the value of this land from $20,000 per acre up to $3.00, $4.00, and $5.00 per square foot (over $200,000 per acre) in a matter of months. The final appraisal would be used to justify a construction loan for the development of a condominium project. This same S & L, or others involved in this conspiracy, would then generate permanent end-loans to investors buying these units, and these loans used to pay off the construction loans at Empire. Empire and other involved thrifts would collect loan origination fees for every time the land deals were reappraised, and loans for increased amounts were created, as well as loan origination fees, for the construction loans for the project and end-loans to the investor.

The investors were often induced to sign these loans because the loans were for in excess of the actual cost of the project, and they were able to walk away from the loan closing with a substantial check of tax-free money. Other investors bought these highly leveraged investments purely for the tax shelter benefits. The end result was that a piece of land was purchased for $20,000 per acre, and a few months later a loan was made on it for $200,000 per acre (a ten-fold increase) with absolutely no change in the market conditions to justify any increase. Then a construction loan for in excess of the actual cost to build the project was funded creating a loan for $75,000 to $80,000 per unit for units which were nothing more than apartment projects under construction by other builders (land, materials, labor and capital) for $35,000 per unit. In Empire Savings & Loan, probably $200,000,000 vaporized as a result of excessive land loans; excessive construction loans; excessive loan origination fees; excessive title policy premiums through the flipping and resale of land and units; excessive legal fees required to document all of these transactions; appraisal fees required each time a new loan was made; and surveying costs required each time another tract or unit was sold.

EXAMPLE B

An example of a permitted transaction that became abusive and fraudulent is the ability of thrifts to make loans based on 100% of the cost or appraised value, whichever is higher. It was bad enough to invite lenders to make loans for 100% of cost without requiring any equity capital to insulate the thrift from loss, but it was suicide to permit the loan to be for 100% of appraised value, especially if it was higher than the actual cost.

What we saw repeated time and again was a case in which a borrower contracted to buy a piece of land for $10 million that he wanted to hold for an investment for 3 years. Often these purchasers had no track record in real estate development and were simply high risk entrepreneurs. The lender would provide a loan for the $10 million purchase price plus the $1 million per year for interest and ad valorem taxes. Of course, they also lent the borrower the money to pay all closing costs and loan origination points/fees to the institution. The end result was to commit to a loan that would have an ultimate balanceof approximately $14 million when it matured in three years which is 40% above the current purchase price. Even though the borrower may have given a personal guarantee for

repayment of part of the loan, we often found that the borrower did not have financial resources commensurate with the financial obligations for which they were committed. They certainly did not have the sources of income to service the interest on these loans out of pocket.

Often, at the maturity date of the loan the borrower was unable to sell or refinance the property with another institution. Consequently, the thrift lender would go out and obtain a new appraisal bysaying the property was worth at least $14 million and that they would give the borrower a new loan for $14 million plus the interest for another year or two. At the end of the one year extension, the loan would now have a balance of approximately $15,500,000, or 55% more than the amount for which the property was acquired 4 years earlier.

The fact is the property probably wasn't even worth $10 million at the time it was purchased. When the market began cratering, it became apparent how absurdedly over-priced many of these land transactions had become. When you have speculators and investors outbidding the developer for a piece of property, you certainly know the property is seriously disturbed. The end result is a piece of property with a book value of $15,500,000 that may be worth $8 or $9 million at best.

If prudent loan underwriting practices had been used and a 10-20% down payment had been required with the borrower paying the interest out-of-pocket, the lender would have been in a much more comfortable position. Even if the market debacle had put the price back down in the $8 - $9 million range, they would be looking at a loss of 0-$1,000,000 as opposed to $5.5 to $6.5 million.

Two simple structural changes can be made in thrift lending policies which would alleviate many of the high risks in land loans as well as construction loans on improved properties. One is to make the maximum loan permitted a percentage of cost or appraised value, whichever is lower. The second change is to limit the maximum loan to 80-90% of that amount, just as in single-family loans.

EXAMPLE C

The credit underwriting policies of most thrift loans we reviewed were extremely lax, at best, and virtually non-existant in many cases. It always confused me as to how borrowers could walk into the single-family residential side of an S & L and be required to fill out reams of documents supporting every cent of income and net worth on a loan for $75,000, and yet they could walk into the commercial side of that same thrift and borrow $10 million and they weren't even asked for a financial statement. The extensive failure to provide prudent credit checks and to underwrite professionally the loans made it clear to us that the people making the loan were thinking only of funding the loan and to not whether or how it eventually might be paid back.

EXAMPLE D

One of the first thrift loans we were asked to review was on a medium sized office building at the edge of the CBD in one of the major Texas metropolitan areas. The loan was almost fully funded but the project was only two-thirds completed. The S & L was also exceeding their loan-to-one-borrower limit on this project, and tenants who had signed pre-leasing agreements were apparently not going to be able to honor their lease commitments. The lender had done an extremely poor job of loan documentation and their over-funding of this project was inexcusable. This project was a classic example of a lender being totally incapable and unqualified for originating, monitoring and servicing a commercial real estate loan in an area in which they had absolutely no experience. This was a rampant problem throughout the entire system.

Deregulation provided absolutely no transition for thrifts from single-family home loans to commercial real estate and other ventures. One day a loan officer was making loans on single-family houses, which he had been trained to do, and the next day he was making loans on multi-million dollar commercial real estate projects, for which he had no experience.

EXAMPLE E

Another frequent occurrence was the making of accommodative loans between the members of the "Texas Daisy Chain". These were owners of thrifts who would finance the personal investments and stock loans to acquire thrifts for each other. They would also swap each others bad loans back and forth. In one case, the owner of Thrift A would borrow money from Thrift B for the purchase of a Houston apartment project. The acquisition loan would be for 100% of the cost of the acquisition. Of course, the loan would include generous points and fees to the lender. The owner of Thrift A would then sell the apartment project based on an extremely favorable loan created by his own thrift to an investor. Thrift B would be paid off and Thrift A would create a new loan, which also had generous points and fees booked as immediate profits. This was an extremely wide-spread practice and there were numerous Daisy Chains. The frequency, size, and volume of these transactions certainly could lead to the assumption that fraud was involved. There is also the question of how all of these loans have been able to obtain the required appraised values.

EXAMPLE F

Then, of course, there is the case of one of the largest Arkansas S & L's at which over 20% of the stock was held by two principals, plus other family members and trusts. These two principals also became largest borrowers from this publicly-traded S & L. There have been SEC questions raised about their possible failure to disclose their closely held interests. These two principals had been partners for many years.

There are certainly serious questions regarding conflicts-of-interest being investigated.

EXAMPLE G

One of the land loans we reviewed had a total loan commitment of approximately $8 million with $1.5 million specified for funding of development for streets and utilities. The developer had experienced considerable delays in obtaining the required zoning and platting approvals. The institution simply reallocated funds designated for development to the interest reserve account so that the loan ultimately matured fully-funded with virtually no development having taken place.

EXAMPLE H

What do you do when you have a major Texas home building company that defaults on a $40 million loan secured by developed single-family lots; partially developed single-family lots; raw land, completed single-family homes; and partially completed single-family homes and you foreclose on the collateral but want to get these assets out of your REO category as soon as possible? In this instance, the creative thrift got a seriously crippled local home builder and a weak local Realtor to form a shell company to "buy" these assets. At that time, the two individuals had a combined net worth below $500,000. A loan was made to these "buyers" for approximately $45 million, plus a substantial interest reserve to pay the interest on the loan. Additionally, another loan was set and made to another newly created company that would build homes on the developed lots and finish construction on the partially completed homes. The Realtor would handle the marketing of these properties. The S & L then also provided 100% financing to the building company for construction of the homes with a take-out commitment for end-loans.

This loan was made at a time when the local market was leading the nation in single-family foreclosures, and approximately 40,000 homes were listed for sale in the Multiple Listing Service. In addition, the institution was operating under a Supervisory Management Agreement.

EXAMPLE I

The Dallas real estate community was asking a lot of questions when an individual who was a substantial stockholder of one of the state's largest thrifts negotiated the purchase of a piece of raw land for $160 million and obtained a commitment from that thrift for a commitment of close to $300 million for acquisition, development, marketing, and interest reserve. This individual not only sat on the Board but was also on the Investment/Loan Committee. The institution then negotiated a generous long-term contract with that individual to develop the property. At the time that institution was merged under the Southwest Plan, it had funded almost $270 million, and the FSLIC was forced to take over title and responsibility for that asset.

EXAMPLE J

Many of the high-flying S & L's had at least one or two airplanes, usually jets, that were used generously for the personal benefit of officers, friends and clients. We believe that the Justice Department and FBI will be able to document extensive abuse in this area.

EXAMPLE K

In this case, major shareholders of a publicly traded S & L, who were major players in the land development market, borrowed in excess of $20 million for the purchase of hundreds of acres of land that were in a designated flood plain. This means that you could not develop on most of this land without spending an enormous amount of money to reclaim it and bring it out of the flood plain (which is extremely expensive), and by first obtaining approval from the Army Corps of Engineers to do so (which usually takes a long period of time). Not only was this an extremely risky loan, but when we were asked to review this transaction by the federal regulators we found that neither the borrower nor the lending institution had bothered to prepare development cash flow projections to show how and if this loan could be repaid through the intended development process. Was this transaction fraudulent? Probably not, but it certainly appeared to be extremely imprudent and possibly irresponsible.

EXAMPLE L

Is it fraudulent when a major shareholder and director of a thrift personally negotiates the purchase of land for $160 million, and then also negotiates the financing of this purchase with the institution in such a way that he has no liability or personal exposure in this deal, but also negotiates for his own development company a development and management contract on a lucrative long-term basis?

EXAMPLE M

One of the many appraisals we reviewed in our consulting practice did a very professional job in obtaining and presenting extensive market information regarding single-family residential development in Austin. It was clear from reading through the presentation of this material that the market was already overbuilt, and with 5,000 additional lots in the platting subdivision approval process, any plans for additional lots verged on insanity. However, in drawing his conclusion, he totally disregarded the other 5,000 lots being planned and apparently assumed they would never come to market. When we challenged the appraiser on this issue he was left defenseless.

Was this loan fraudulent? Even if the appraisal wasn't fraudulent, why wasn't the fallacy in this appraisal caught by the internal appraisal review staff, the loan officer, senior management, Directors, auditors or federal/state regulators.

EXAMPLE N

One of our first major consulting assignments was to go into one of the State's largest thrifts and review 12 transactions selected by the Federal examiners. We basically found two types of transactions. The first group were those negotiated by very experienced professionals in a mortgage subsidiary of the parent company that owned a controlling block of this institution. These people had a certain amount of independence and applied it prudently. The second group of transactions were loans made by the association for properties acquired through brokers in another parent subsidiary and syndicated in highly leveraged tax shelter oriented partnerships sold by yet another parent company affiliate. We were told by former employees that those transactions were pretty much imposed on the thrift management by the board that was controlled by the parent institution. Even if this was not technically fraudulent, it certainly smacked of flagrant conflict-of-interest.

EXAMPLE O

One of the most flagrant transactions I can recall (and there were many), involved a former shareholder and officer of one of the largest insolvent institutions in the state. One day it was announced in the paper that he was leaving the institution as an officer and shareholder and shortly thereafter it was announced in the paper that he had borrowed $50 million from this same institution in order to undertake a very large land development project. This individual had no previous experience with direct involvement in land development projects. Additionally, the land had previously been owned by the controlling shareholder of yet another savings and loan that became equally as insolvent.

EXAMPLE P

The exploits and activities of one high-profile "land flipper" detail how he bought, sold and traded almost $300 million worth of raw land. He admitted to having no land development experience and to not even having anyone on his staff who had any land development experience. This individual was 29 years old when he started this activity. His net worth and cash flow were totally generated by flipping highly inflated land deals with S & L loans. An estimated $100 million was obtained from a Texas thrift that became known as one of the notorious gun-slingers.

EXAMPLE Q

An often used phrase in the late stages of the speculative land bust and the thrift collapse was "trash for cash". The term should have actually been "trash for trash". During the last days of Rome, so to speak, many of the institutions would retain brokers to package their problem loans that could no longer rolled over or flipped and would begin a series of swapping a bad loan at Institution A for a bad loan at Institution B. In this way, Institution A would get a bad loan off of its books and be able to book a new loan plus the points/fees on its books. The same thing for Institution B. Of course, this required a conspiracy among management, appraisers, accountants and attorneys to expedite this transactions.

6. Were the alleged or fraudulent activities you saw or know of due to a failure to supervise by the relevant regulatory institutions?

Answer. As I have stated previously, there was a total failure of the checks and balances system, where the checks and balances existed. Unfortunately, many of these checks were not even in the system, as they are in the banking industry.

There are many reasons and excuses given for the regulator's failure to detect early warning signs and exercise their powers to investigate or halt those activities. One reason given is that many of these thrifts were not even examined by state or federal regulators for two or three years. Another reason given is that the regulators did not have the personnel with the experience and training to examine the numbers of large extremely complicated commercial transactions. They also could not afford to pay the wage scales required to attract the level of expertise required. The bottom line is that there was a total failure of the state and federal regulators to supervise and regulate the industry.

7. If there were failures to adequately supervise by the relevant regulators, what in your view caused those failures to occur?

Answer. There were numerous causes for these failures. Some of the reasons given immediately above are in fact legitimate causes. But the real cause goes back to the very legislation that permitted thrift deregulation. Some people obviously interpreted deregulation as meaning non-regulation. If the commercial banking system had been used as a model, the legislation would have provided for the structural changes in the entire S & L system at the top as well as simultaneously providing a framework in which the thrift industry could make a transition into these new investment areas with proper supervision.

The ability to approve the chartering of a national savings and loan, the authority to establish policies and procedures for the entire industry, and the responsibility for examination and supervision and the depository insurance fund are all under the Federal Home Loan Bank Board. In the commercial banking system, the Office of the Comptroller of the Currency is under the U.S. Treasury and they have the authority and responsibility for issuing national bank charters, examination and supervision. They are totally independent from the Federal Reserve Board and the FDIC. It is clear that the OCC's ultimate responsibility is to the United States Treasury.

In the thrift industry, the lines of responsibility are not as distinct, and the thrift industry trade groups have been able to exert considerable industry influence and political pressure throughout the Federal Home Loan Bank system.

8. What changes in the regulatory system of supervising S & L's would you recommend?

Answer. A. Change the entire structure of the Federal Home Loan Bank system so that there is a truly independent supervisory and examination arm that is responsible to the United State Treasury so that it is clear that it is their responsibility to protect the safety and soundness of the depository system for the benefit of the depositors, rather than for the owners and managers of the institutions.

B. Chairman Ed Gray moved the examination responsibilities from Washington to the Regional Bank location. This change should be maintained to allow the examiners a better opportunity to monitor the economies, market conditions and activities in their own region. However, they should be ultimately responsible to Washington.

C. Provide the additional funding for adequate staffing of the examination department.

D. Raise the pay scale of examination and supervisory personnel so that the FHLB can attract and keep qualified people for a long period of time.

E. Establish an effective means for Federal and state regulators to work in concert using the same standards and guidelines for state chartered thrifts that have FSLIC insurance. If a state chartered thrift wants FSLIC insurance (which it needs in order to exist and operate), then why should it be allowed to operate anymore liberally or any less supervised than a nationally chartered thrift. Either state thrifts need to have a larger capital requirement, a greater insurance premium, a lower ceiling on the level of individual deposits covered or, they must comply with all of the requirements imposed on nationally chartered thrifts.

9. Do you think any of the losses due to fraud can be recovered and if so, how?

Answer. The first step in recovering any of these losses is obtaining criminal convictions or negotiating plea bargains. Even then, I suspect is would be extremely difficult to find a lot of these funds which are probably squirreled away in foreign countries. Even if you could obtain a conviction and prove that funds were illegally obtained and used for building a $6 million house in North Dallas, that doesn't go very far in trying to recover $75 to $85 billion.

10. Did accounting and appraisal firms dealing with S & L's in the Dallas area carry out their responsibilities in a professional manner.

Answer. There are many cases of Southwest area thrifts having been given clean audits or even qualified audits by their independent auditor only to have them declared hopelessly insolvent a few months later by federal examiners. This did not happen merely because federal examiners were excessively tough in applying accounting or evaluation standards. It was simply the result of a truly independent and unbiased party thoroughly penetrating enough transactions to answer questions that were apparently never asked by the "independent auditors".

Many of the most severe abuses in thrift losses are in the state chartered thrifts. In most of these cases, the institution was owned by a very small group of stockholders with one or two individuals holding controlling blocks. It would seem that the independent auditors felt that their allegiance was to "protecting" the investment of the shareholders, rather than the safety and soundness of the institution for the benefit of its "debt" holders, the depositors. It is my conclusion that there is considerable culpability on the part of auditors who failed totally in conducting proper and comprehensive audits.

One of the first duties of the auditor is to determine the soundness of the internal control environment within the institution. In other words, are there checks and balances in place internally so that the board of directors feels comfortable that the appraisal review, credit check and loan underwriting have been properly challenged prior to their review? In other words, is there a proper segregation of duties and responsibilitias? The second step of the audit is to conduct compliance testing. In this phase, the auditors conduct a sampling of specific transactions and procedures to verify that senior management has been telling them the truth. At this second level there should have been numerous questions raised based on our review of hundreds of individual loans. There was very poor documentation in general. Specifically, there were often times key documents missing or adequate documentation to track the loan from inception to final funding. The greatest abuse was probably in credit checks. We consistently found grossly inadequate credit checks on the borrowers. The most commonly found content in a credit file was simply an audited financial statement. There was absolutely no evidence of conducting any kind of credit check to verify any of the information on the statement.

The compliance testing phase should have raised enough questions to require a thorough implementation of the third phase of the audit, substantive testing of specific transactions. This requires broadening the audit to more transactions and reviewing the entire loan documentation, appraisals, and credit checks. It would appear to me that many of these accounting firms were no more qualified to determine the market value of collateral or the credit worthiness of the borrower than the state and federal regulators. The accountants were certainly a very weak link in this chain.

They spent more time using their skills to explore the extent to which they could creatively apply RAP accounting. Although the accounting firms used the availability of RAP accounting as an excuse for not disclosing problems, they were certainly irresponsible in not questioning the ability of the collateral and the borrower to repay the loan, regardless of what accounting techniques might have been applied.

Many appraisers were also co-conspirators in the wide-spread fraud that occurred in this institutions. The honest professionals in the appraisal industry are working hard with the U.S. Government to formulate legislation that would create national standards for appraisal certification at the state level. This legislation would require that all appraisers would receive a license from their state. Additionally, appraisers would fall into two classes. The first class would be certified. This means that they would be either certified or non-certified by the state. The certified appraiser would have more rigorous testing and would be required to have greater experience. Only certified appraisers would be allowed to provide appraisals for depository institutions with federal insurance. This process would be similar to that used in most states for Certified Public Accountants.

In 1987, the eight major organizations issuing the appraisal designation adopted uniform standards of practice. They also now have an appraisal standards board, similar to the accountants' financial accounting standards board. They establish and modify standards for all appraisers nationally. They additionally have set up an appraisal qualifications board that is working on a standardized examination to be used by the states for certification.

The problem is, all of this reform is being accomplished after the fact. And, the fact is, the appraisal industry has been an unregulated, unsupervised, easy-entry "profession" that has allowed itself to be prostituted by more than just a small minority. They have a long way to go to build a reputation throughout the industry that is deserved by a small group.

The abuse we saw in the appraisal profession was unconscionable.

The legal profession has done an exemplary job of creating extremely expensive product and service liability for every other business and profession in the country, except their own. The one group that probably had the best comprehension of these complex transactions were the lawyers who had to pull all of the pieces together into legal documentation. Don't they suspicion at the sheer volume and velocity of all of these transactions? Weren't they suspicious when they closed the third loan on the same piece of property in the same day at two or three times the amount of the first loan? Weren't they suspicious of the potential conflicts-of-interest in seeing thrift owners and managers swapping problem loans back and forth between their institutions? Who was mora qualified and better prepared to cry "foul" when so many transactions were so highly suspect, raised questioned of business ethics, and conflicts-of-interest, if not just plain fraudulent?

11. Do professionals familiar with the fraudulent activity that took place in S & L's in the Dallas area believe the perpetrators of such fraud are being brought to justice?

Answer. Absolutely not! The professionals in the commercial real estate and financial services industry throughout Texas and the region know that the perpetrators of these fraudulent activities are not being brought to justice.

The professionals were asking in the very early stages of this extensive sham how long it could possibly go on before it was shut down and the "crooks" be locked away. The professionals know that one of the primary factors for the current disaster in the commercial real estate industry throughout the Sunbelt is because of the deregulation of the thrift industry and the weak investors that took advantage of it.

The greatest crime of all would be for the "crooks" to not be indicted and convicted!

The **Chairman**. Mr. Gleeson, you touched on a couple of the factors, but you were in Texas. This is what was happening in Texas. If you look across the country, in most places that wasn't happening. In most other States that I'm familiar with we don't see anything like that pattern going on. It certainly wasn't going on in my State of Michigan, and I gather most of the other States in the country.

It seems to be not uniquely a Texas problem, but certainly very differentiated there from other places.

Why was it so extreme in Texas?

Mr. **Gleeson**. I have asked a number of people that question over the years and in the past week or so in preparation for this testimony. I have gotten a number of answers, but again, I think you've got to look at the oil boom and what that was doing to the creation of jobs and to job growth.

The **Chairman**. What about the State laws? What about the expansion of State powers beyond the Federal powers? What about the State regulatory structure? To what extent is that or is that not a factor? What you're describing here is a pattern of self-dealing and flipping these real estate deals over and so forth that seems to me to be the most extreme case that we find anywhere in the country.

Mr. **Gleeson**. Clearly part of the problem—one of my comments is, oftentimes you couldn't tell the difference between the Texas S&L department and the Texas Savings and Loan League.

STATE REGULATORY PROBLEM

The **Chairman**. So there was a State regulatory problem?

Mr. **Gleeson**. Clearly. These people were not experienced and qualified to examine complicated, complex real estate. They didn't have the budget. They didn't have the background. They didn't have the people. And I think there was some inherent conflicts there in that examination and supervisory system clearly, yes, sir.

The **Chairman**. I'm still trying to understand why there was so much of that in one State rather than another. We were asked about this, Senator Garn and I, a number of times, and that is, the degree to which the add-on of State powers or authorities to get into riskier activities in an absence of supervisory capability to monitor the much higher risk profile that goes with those activities appears to be a very central part of the problem in Texas, which is the worst part of the problem in the country.

Is that right or what's your professional view on that?

Mr. **Gleeson**. Well, two comments. One side again is the economic expansion. In your own State, if you try to envision the major auto makers in Michigan doubling their capacity in the next 3 or 4 years and the kind of job growth, the plant construction, the office leasing, the shopping centers, the home building, and the tremendous boom that it would create in your economy, and if you assumed, as did many people in the real estate and the energy industry, that that type of growth would be extrapolated out into the future ad infinitum, you just keep building and you keep borrowing and you keep——

The CHAIRMAN. The difference is we don't have those rules in Michigan that exist in Texas that really blew the game wide open. Isn't that really a critical part of this problem?

Mr. GLEESON. Absolutely. And as Mr. Selby alluded to earlier, we created some pretty liberal State regulations or deregulations of Texas S&L's with regard to direct investments. California went to the extreme before Chairman Gray finally put a halt to it.

The CHAIRMAN. Do you agree with that, Mr. Selby?

Mr. SELBY. Yes, I do. And I would say this also, and support what I had said before. Yes, I think the industry and the regulators at both the Federal and the State levels were intertwined, some by statute and some simply because of tradition. Certainly at the State level, as David said, the State commission and the Texas League are very closely aligned, whether formally or not. I think that's been recognized by the present Governor actually.

At the Federal level, I think there are inconsistencies. I brought that up in my testimony. When you have a Federal Home Loan Bank that is the chief supervisor of federally insured thrift institutions and the board of directors of that is composed by a majority of the members that they are supervising. Now I don't think that happens in every Federal Home Loan Bank, but as David said, in Texas and in the Southwest and in Oklahoma and Colorado or wherever, there was this growth factor that was just absolutely an explosion and here the regulators are sitting, still looking at home mortgages——

The CHAIRMAN. And to some extent the captives—or so you're describing them—of the industry itself.

Mr. SELBY. Absolutely.

Mr. GLEESON. And if the State S&L's want the freedom in their charters, then maybe they ought to be taken on as coinsurers with FSLIC if they want that additional freedom. Otherwise, there's little reason why they should be able to do anything different if they're going to have Federal deposit insurance than the nationally chartered thrifts.

Senator BOND. Mr. Gleeson, if I might interject, as one who has spoken out many times in the past and will do so again about the rights of States to make decisions about functions within their jurisdiction, whether they're right or wrong, we ought to learn from it. The problem here was that they were still able to take these risks on the Federal insurance system.

Wouldn't it make sense in our reform proposal to give greater powers to the insuring agency to say, "Texas, if you want to allow an organization called an S&L to do these things, they can't get FSLIC or now FDIC subheading thrift insurance for it," and limit the scope of insurance through an independent insuring agency.

Mr. GLEESON. You could either make the State a co-insurer or cut the amount of insurance for those types of institutions back, increase their capital requirements, a number of things. But in the bottom line I think you've got to take the burden off the FDIC and FSLIC.

The CHAIRMAN. On that point, Senator Bond, it seems to me that what we need to do is to undertake in the legislation to line up the federally granted authorities that rest on the Federal deposit insurance guarantees with what's allowed out in the States. Senator

Garn has raised this issue many times, as have I. I feel very strongly that we've got to set outer bounds here that are in the law.

Now regulators have got to have a little bit of flexibility, but regulators come and go. Sometimes you get a good one, sometimes you don't. Sometimes somebody has got a philosophy that says it's time to have a very liberal view of what expanded powers might be and at other times it's a different view, and it just seems to me it's almost a fundamental principle that if we're going to put Federal deposit insurance in the name and the wallet of every citizen of this country on the line to protect certain activities, we'd better prescribe what's allowed and what's not allowed.

Mr. SELBY. May I interpose something? In talking about that, I think that's right and I'm not an expert. Senator Garn is because it's called the Garn-St Germain Act. But if indeed we at the Federal level hadn't had the ability to override the State commissioner on the receivership requirements—and I think it expired at one point and finally it was extended—we really would have been in a pickle. Eighty percent of the thrift institutions in the State of Texas were State-chartered.

The CHAIRMAN. It's not surprising why. Senator Garn has asked to be recognized. I'd like to recognize him at this time.

Senator GARN. Thank you, Mr. Chairman.

Mr. Selby and Mr. Gleeson, it's nice to have you here. I'm sorry I had to leave for a few minutes but I have had the opportunity to read your testimony while the chairman has been talking.

I would like to pick up on the point that was just being made by the chairman. You mentioned Garn-St Germain. I get a little bit tired of being blamed for what Garn-St Germain did because if I went back to 1982 and the circumstances of disintermediation I would pass exactly the same bill all over again, even in hindsight. And as I discussed earlier, we allowed a grand total of 3 percent in direct real estate investments, where Texas was 30 and California was 100.

And if you look at the statistics, the majority of failed institutions in numbers are State-chartered institutions and a much larger percentage in terms of the losses that we are looking at are State-chartered institutions. So I think it's clear that what the chairman was alluding to is that the major problem has been in what State legislatures allowed.

FEDERAL INSURANCE AND STATE-CHARTERED INSTITUTIONS

So then you get back to this question of, fine, I believe in States rights like the Governor does, and I believe in allowing legislatures to do what they want to do with their State-chartered institutions and the dual banking system. Then the question is, if they are going to have Federal insurance, then do we say you have to have Federal standards apply to you if you want that, or fine if you just want to be a State-chartered institution you look elsewhere for insurance?

It's easy to come to that view in hindsight and say we probably should have done that. But on the other hand there's been a lot of innovation in State institutions—NOW accounts and the New England experiment and all of that.

Do you have any idea how you do draw that line, rather than just a cold hard line that says, OK, if you want FDIC or FSLIC you have to apply with Federal standards regardless of what your legislature says; or is there some way to correct that problem and still allow the dual banking system to work with some innovation out there. We take so long to change anything here, that there are a lot of good things that have happened from State-chartered institutions that we simply never would have allowed if those experiments hadn't started out there. I don't know where to draw that line, but it's got to be drawn someplace.

Mr. SELBY. I'm not sure I have a solution, Senator Garn, but I think there are some things that can be done. I had the same frustrations when I was at the Comptroller's office and went through several phases where there was a wide spree of chartering of financial institutions and banks, particularly in Texas, sometimes in California.

I think one thing can be done at the Federal level is to give the insurance funds a better ability—and I said it in my testimony—in the change of control or entry into the system. I think the standards maybe for deposit insurance are not as strict as they should be for State-chartered institutions. I think that whole issue could be looked at and maybe there ought to be more turndowns. I know in Texas finally, after it became so bad, the Bank Board basically said, no, we're not going to insure any more institutions in Texas or very few, and they have to pass a great deal of scrutiny.

The unanswerable problem is you have a State of Texas that has 230 savings and loan institutions and you have 40 examiners and you have a growth from $40 billion to $100 billion industry in 3 years. There's no way 40 examiners or 60 examiners can supervise a banking system or a thrift system. So therefore you have the State constraints right there.

I think how the FDIC has approached it in the commercial banking industry is coordination with the State and taking on more of the supervisory load for the States—joint examinations, the State uses the FDIC's examination reports, things like that.

I was told that that was tried in Texas in the thrifts before I got there but, unfortunately, it was put up on a shelf and allowed to die. And I do think there should be mechanisms in Federal legislation that allows the override of States.

And on Garn-St Germain, I think we needed the deregulation. There's no question about that. It wasn't the fault of deregulation. It was the fault of a lot of things that went with it that contributed to the failures.

Senator GARN. Well, you bring up another point. I'm sure you remember that one of my big frustrations in 1986 came about this time of year when the Secretary of the Treasury and Ed Gray came to me and asked me if I would give up on my deregulation bill of 1986. I had the $15 billion of FSLIC recap incorporated in that, but they wanted me to just go with the $15 billion FSLIC recap, which in June I decided to do. I said:

> OK. This problem is serious enough that I'm going to abandon everything else and all this committee is going to do is pass $15 billion FSLIC recap.

The House only wanted $5 billion. The industry was berating me daily because they only wanted $5 billion. And I said, well, that's unfortunate and with Senator Riegle's help in the closing days of October 1986 we did pass a $15 billion FSLIC recap. And it's still a very sore spot that the House, in light of what we're estimating was a hemorrhaging at $6 to $10 million a day 2½ years ago, wanted a large housing authorization bill that they wouldn't give up. So it failed.

But also, that was the same night that we sent over to them an extension of title I and title II of Garn-St Germain which contained some of the tools we had given you in 1982 to be tougher on regulation and mergers across State lines and an override of State institutions. I'll never forget how mad people were with me, in some cases saying, "You have abandoned your traditional States rights philosophy." And I said, "Well, we've got a difficult time and it's necessary to do so."

We left session not only not giving the Federal Home Loan Bank Board additional tools and no new money; we didn't even give them the existing authority that they had had for 4 years until much later when we came back in session.

So I must admit I'm still bitter at the House of Representatives playing games with the housing authority. The next part of that is that I can't tell you how many calls I had from industry types, particularly in Texas but also in other places around the country, complaining about Ed Gray and his regulations and how he was being too tough. I didn't even relay them to Ed Gray because I didn't think he was being too tough. I didn't bother to tell him, but it was just a constant complaint when I would go out to give a speech, "You know what Ed Gray is doing here and there" and I said, "Well, I believe he's doing it for a good reason. He is not just trying to close down institutions for fun. He's got other things that are more pleasant to do."

But, to get to the point, in this whole process one of my other great frustrations was those in the House of Representatives who wanted some of the most ridiculous forbearance provisions. Some of those people are still in hearings trying to assess blame on somebody else. These are some of the same human beings that wanted forbearance. And I fought those forbearance provisions. Unfortunately, we got them watered down, but there were some of them still left in CEBA in 1987. Chairman Proxmire and I just couldn't get them out.

My question is, should those additional forbearance provisions to keep institutions open be repealed?

FORBEARANCE PROVISIONS IN CEBA

Mr. SELBY. I had that in my opening remarks and I didn't get to them. Quite frankly, those provisions in CEBA, as I was saying, here was this great movement and the hole was the FSLIC recap bill. Absolutely it was held, as you say, and we were under the same types of pressures you were, but to put in provisions—two that rankled me the most as a supervisor—and I was just a little supervisor in Texas in the middle of this—was forbearance. What in the world is forbearance anyway? How can you forbear on an institution—disregard whether it has fraud or anything—but its liabilities exceed its assets. Now what are you going to forbear on?

The Congress has said we have an insurance fund for insolvent institutions. We have a regulatory system to supervise our financial institutions. Now we are to forbear? It's ridiculous. It's a ridiculous discussion and forbearance is a ridiculous issue.

Second, you have in there an arbiter. If something goes wrong and somebody doesn't like what a regulator does, then you have to go through an arbitration panel, of all things. And I've been a regulator 34 years and I can tell you there are so many stages of arbitration that exist now in the Bank Board system and in the Comptroller of the Currency's office and in FDIC, that it's ludicrous to think we need now somebody up here at the top who is independent to make decisions on a supervisory or regulatory decision.

Part of my spiel was we already were delayed in taking actions and doing things that I think would have saved FSLIC money in the end.

Senator GARN. I'll tell you exactly what happened. As you remember, the House only passed $5 billion a year after we had passed $15 billion over here, and the Senate then only passed $10 billion. And the constant threat was that if you didn't give up trying to get these forbearance provisions out, there wouldn't be any FSLIC recap. So finally it became a tradeoff and we jacked it up to $10.8 billion.

So I had to agree in that conference with the House to allow some of those forbearance provisions to stay or not only weren't we going to get $10.8 billion, we weren't going to get $5 billion. I was caught in a trap. I can't leave session again with no money for the Federal Home Loan Bank Board to close these institutions. As I say, I'm still bitter and you described it far better than I. You've got a crisis. You've got all these institutions that are brain dead and if you apply GAP accounting they're absolutely gone, and we've got politicians that want to forbear. I didn't understand it. Why? Why don't we just close them down?

So I suppose the answer to my question is, yes, your position is the same as mine was; they ought to be repealed. They never should have been in CEBA to begin with.

Mr. SELBY. Absolutely.

Mr. GLEESON. I concur and I would like to suggest you consider that in new legislation. I think a lot of the forbearance was simply due to political pressure and maybe in hindsight some of the people who were pushing for it as more and more of these questionable transactions get out on the table—in any other industry, if an entrepreneur goes out to make hoola hoops and all of a sudden people stop buying hoola hoops, you don't get forbearance to try to keep your company alive. And these institutions were competing in the free market system and there aren't any of the institutions that someone else can't come in and pick up their franchise.

If I might make one other quick comment——

The CHAIRMAN. Well, before you do, and I think Senator Garn's comments are very important ones to have on the record here. I think it is also the case that as we look at the unfolding of this problem over time there are a number of points along the way where the gamble was taken to buy time in the hopes that the situation would self-correct. And I can see when the RAP accounting was introduced rather than GAP accounting, when capital standards were lowered, where a whole series of steps were taken at different times to try to buy time, to try to skim through this situation in the hopes that either the Texas economy would turn around, value would come back into some of the real estate ventures and so forth, that if a way could be found to sort of let the problem go a little bit longer, maybe double the bets and hope that things would work out, that somehow the situation would right itself without a calamity sort of overtaking the system.

I think you can see that psychology surrounding a whole series of events and actions over a period of time. At least that's the view that I have developed as I've tried to reconstruct it. You nodded, Mr. Gleeson. Do you agree with that or disagree with it?

Mr. GLEESON. Yes, sir.

The CHAIRMAN. Do you, Mr. Selby?

Mr. SELBY. Yes.

The CHAIRMAN. Thank you. In any case, I want to make two other observations just with respect to this important record that Senator Garn has put together.

I was reviewing the issue that you raised, Mr. Selby, of having sufficient regulatory strength to get the job done, just having enough people to be able to do the work to carry out the supervision in this sort of wide open game, especially in a place like Texas.

The records we have indicate that the Texas authorities at the time had the most wide open rules of any of the States and only had 17 State supervisory people working in the Texas S&L system. Am I right in that number?

Mr. SELBY. That's probably right. I don't know the exact number.

The CHAIRMAN. I'll correct the record if I'm wrong, but I'm quite sure the number was 17. But given the scale of the duties that had to be performed, in effect it was like having nobody, even if these 17 were superhuman they obviously couldn't do the job.

Also at that time we were running into a problem at the Federal level where the Gramm-Rudman-Hollings regime was cutting in—or some people wanted to cut in to the degree to which the regulatory authorities at the Federal level could add the personnel they needed to do the supervisory job, part of which, Mr. Selby, you were doing out there—trying to do it with insufficient people and resources. And I went back today just to look at the record because we had something of a fight on the Senate floor on March 27, 1987.

EXEMPT S&L REGULATORS FROM GRAMM-RUDMAN-HOLLINGS

Senator Garn and I and others on the Banking Committee had come forward with a legislative proposal to actually exempt the S&L regulators from the discipline of Gramm-Rudman so that they could add the people so that we wouldn't have just artificial limitations on staff or even reductions in staff at a time when, as we can clearly see now and was clear then, we needed to help. It was not an easy matter to resolve at that time. We eventually won that fight, they were in fact exempted and that created the opportunity for them to be able to start to add the additional people that were desperately needed.

So there were a lot of points along the way where an effort to try to catch this problem as it was building up on us. Some of the efforts appeared to have worked, some helped, some probably restricted the size of the growth of the problem and others came late, and others did not get the job done.

Let me ask you another question here. I beg your pardon, Mr. Gleeson. You had a point you wanted to make, so why don't you make it now.

Mr. GLEESON. Thank you. Clearly, the greatest losses are going to be incurred through very, very speculative and reckless investments in land and one thing that the committee might consider in differentiating between what State-chartered S&L's can do and what national-chartered S&L's can do, there's really a question about whether or not they belong in the land investment and land lending business, certainly to the scale that they were in.

One institution that was just taken over in the Southwest plan had funded in one development $270 million in one transaction. How much of that they will ultimately be able to recover on a net present value basis, maybe 50 cents on the dollar.

In my written report, again, when you can make a loan for 100 percent of the cost, plus rolling in all of the interest reserves to carry the loan so the investor is never out of pocket a dime, you roll in the points and the fees to the institution. He buys a piece of land for $10 million. He gets an appraisal for $12 million. He puts $2 million in his pocket, pays the seller $10 million. He also borrows another $3 or $4 million for interest reserve and ad valorem taxes for the next few years. There's no way in God's green Earth that the borrower has got the kind of financial statement or net worth to service that kind of loan or pay it back.

On the other hand, if those institutions could only have been permitted to make loans at 80 to 90 percent of appraised value—you go into a savings and loan association and you want to buy a house and they will make you a loan for 80 or 90 percent of your cost and you've got to verify your income, you've got to verify your employment, you've got to get 3 years tax returns. We'd go into these institutions and look at the files where that same individual could borrow barely $100,000 for a house and they lent him $10 or $15 million on a speculative land deal. No credit check. He had a financial statement in his file, most of it inaccurate and incomplete, and certainly unaudited. And if you can keep these S&L's out of the land and land development business, I think you'll come a long way in preventing these kind of abuses.

The CHAIRMAN. I don't know if my colleagues have this same question in their mind. This is a supervised industry. It's a regulated industry, for the obvious reasons, because we have Federal deposit insurance and it's a very important industry to the country. You've got a supervisory structure. There's reporting requirements. There's a need to have certified public accountants come in and do their certifications. You've got a normal auditing process I assume that both the Federal and State regulators are supposed to do on a regular basis. There is a whole system that's in place for the precise purpose of policing activities like this and to not let them happen, and when they start to happen to blow the whistle.

I think the public is asking the question, what happened to that system? How could that system fail on such an enormous scale when in fact there is a whole structure out there designed to be in effect the cops on the beat that could spot this stuff and blow the whistle and put a stop to it before it ever mushrooms into a $100 billion problem.

How could it be that the regulatory process, including the outside accounting profession that's supposed to spot this problem and blow the whistle, wasn't able to do so?

Mr. Selby, what's your thought on that?

THE SYSTEM BROKE DOWN

Mr. **Selby**. Well, it failed obviously. All aspects of it failed. The supervisory structure was not there. When it finally was corrected by Ed Gray transferring examiners to the Federal Home Loan Banks, increasing the staffing then, and the pay, unfortunately, it was too late. It had already been done.

The story of the Dallas bank had moved from Little Rock and when it moved to Dallas they had I don't know how many examiners—40 examiners and maybe 5 supervisors—and an industry that suddenly became $130 billion industry in district 9 and they were still operating as they had before. So there was no regulatory structure there that was adequate to do what they should have done.

The accounting industry, they are culpable and they have their rules and standards that, unfortunately, I think some of those standards were not followed. The accounting industry, unfortunately, when they are required by the Bank Board to do an audit of a financial institution, they are being paid by the financial institution who is their client and I don't know if that guides them in what kind of a statement they issue or a certification of what they find, but I don't think the accountants, like the supervisor, did a good job in looking at the quality of the assets or looking at the factors that were made in the underwriting of those assets and then the appraisers certainly—we in the banking industry or in the bank regulatory function never put a great deal of strength on appraisals, but then we didn't have a lot of real estate loans in the commercial banks. But the appraisals were made in a heady atmosphere of rising prices and I can't explain. David is much more familiar with the appraisal system. But the fact is, the appraisals did not support the values.

Senator **Bond**. Mr. Chairman, there is one other area—since my colleague from Texas isn't here and he would delight in bringing this up, but Mr. Gleeson, on page 22, points out another group that needs to share in some of the blame and, just for the record, will you tell us briefly about your view of the role that the legal profession has played in this whole scam?

THE ROLE OF THE LEGAL PROFESSION

Mr. **Gleeson**. Well, in the chain or in the formula for this disaster, a couple of components I had not gotten to in my earlier comments—Senator Dixon earlier had made reference to the board of directors. Clearly, somewhere along the line there were many directors who should have stood up and just said no. It's hard. It's unconscionable to look at—even at the time they were doing it, not just in hindsight and retrospect—the kind of transactions that were approved. I think and I know in some cases that in one instance I'm thinking of where the chairman was also a principal shareholder, the single largest shareholder, just simply kept from other directors, even friends, what he was actually doing, what was actually going on in some of the losses that they were incurring.

But when you take and piece all of these transactions together, the attorneys were the ones that got you from A to Z. They are the ones who documented all the entire transaction. They are the ones who oftentimes were giving counsel and advice to the institution and they are the ones who packaged it all up and filed it away.

That's one of the reasons why the Justice Department should have a little bit easier time in piecing some of these deals together because they are all papered up and either documents are there that create the paper trail or that by their very absence raise suspicion.

But I think there is certainly culpability in the law profession, that they have done a tremendous job in the legal profession of creating product and service liability for every profession and industry in this country except themselves and I think it's maybe time now that we looked to them for some accountability too.

Senator BOND. Thank you.

The CHAIRMAN. Very good. Senator Garn.

Senator GARN. Just one quick comment. Most of you probably don't know, but years ago in Utah we had a two-term Governor and a three-term mayor of Salt Lake City—he's still alive, he's 90-some years old and still fixes his own roof and so on—and we tried not to get him excited about attorneys, but he did say one day in a city commission meeting to a group of attorneys representing the Salt Lake Bar "Did you know, Jake, that they don't give them diplomas at law school? When they finish, they award them a license to steal." [Laughter.]

He made a career out of attorney-bashing all of his public life.

The CHAIRMAN. I want to just touch on two final items and I appreciate your patience today and your testimony to us.

Mr. Gleeson, let me ask you. The Dallas Morning News I think has done a good job of uncovering fraud in the Texas S&L industry and it claims in one article that fraudulent operators joked among themselves about inadequate regulation and supervision and their motto, so says the News, was "A rolling loan gathers no loss."

Can you tell the committee what is meant by that statement?

Mr. GLEESON. Another saying that many of them had was, "A loan paid back is money that's gone forever." [Laughter.]

One other comment I might throw in before answering that question specifically, I know one of the questions that all of you have in your mind is, how can you quantify, how big is the problem, how deep is the hole, how much money, how many billions of dollars of bonds will you need to sell?

One other saying we have in the real estate profession is, "The best way to make a small fortune in real estate is to start out with a large one."

There is a myth I think in some of the statistics and assumptions and projections about how much can be recovered out of these commercial real estate assets down the line when they are sold and I think some of those projections are very optimistic.

It was literally a joke how easy it was to borrow money from S&L's and banks in Texas. Debt was a drug and everybody was hooked on it. It was addictive. And I made the point earlier that somebody who could barely borrow money for a home loan could go out and borrow millions of dollars for deals for which they had no experience. One S&L's former officer, shareholder, retired—a young guy—retired, sold his stock back to the S&L. Within a month, the same institution lent him $50 million to buy and develop a huge tract of land in the Dallas area. The guy had no experience, no expertise in that area. Again, these land loans where they were rolling them and rolling them and rolling them, they had to get a new appraisal every time they rolled it over. The accountants had to sign off on it and say you've done it according to RAP accounting. There was some examiner who eventually would look at the deal. The board of directors had to approve it. The attorneys had to paper the deal up and document it. Again, nobody stood up and said, "Wait a minute. This isn't right."

The CHAIRMAN. Senator Sasser, along that very line, has asked a related question. It hasn't come up today but I think it's important that it be asked to you, Mr. Gleeson.

Yesterday's New York Times ran an article that voiced the concern of some that the FDIC's recent entry into the management of S&L real estate might lead to property being dumped on the market.

Now you're a real estate expert. If the Government were to put a lot of real estate on the market in an orderly process over a period of a few years, say 3 years, would that lead to a further collapse in real estate prices? Senator Gramm from Texas also commented to me about this as well. That is, when you've got a lot of assets that have been taken back and there's the disposition problem that has to go on, what are the things that have to be considered as to how rapidly that's pushed out there or how does one best view the question of the disposition of the assets do not destabilize the general economy even more than it is, and also to try to realize full value for the Government in this case?

DISPOSITION OF REAL ESTATE ASSETS

Mr. GLEESON. Mr. Chairman, I thought you would never ask the question. That's one of my pet topics.

I think there is a certain amount of myth to that supposition. As an example, the Empire Savings I-30 condominiums, Empire Savings was put into receivership in March 1984, 5 years ago. To this date, FSLIC still owns all of those properties. They are under contract but they still own them 5 years later. I don't think anybody can say that FSLIC dumped those assets.

The FADA has been accused time and time and time again of not moving assets through the marketing and disposition system fast enough. They are not accused of dumping the assets.

And I don't think anybody ever suggested or recommended dumping these real estate assets on the market. What has been suggested is—and I think the only thing that is even possible—is an orderly marketing disposition program where the Financial Assistance Division that was created and set up under FSLIC to monitor all of the Southwest plan institutions is working on a computer model to have those institutions go through a sell versus hold analysis, factoring in cost of funds, yield maintenance fees, et cetera, to have them justify why they should not put that property on the market currently if they can't get more for it 4 or 5 years from now on a net present value basis.

I think that has to be looked at and I think anybody who has the responsibility to look at marketing and disposing of these assets has to use some type of standardized measure. But if you look at the stock market and it looks like prices are down, one of the reasons that prices are down, if you talk to brokers, is because of the low volume. Volume creates bidding. In one case where we went in to make an offer to buy a piece of property from one of the major banks they had recently foreclosed on, there were 32 offers submitted. Now not all those were necessarily legitimate buyers who could perform, but the fact is—and this is not unusual. In Houston, we're hearing about in the apartment market S&L's, banks, various other institutions always putting properties on the market and within a matter of days getting 10, 15 or 20 offers. Apartments are hot right now. Land is cold. You can't sell it. But the biggest losses are going to be in land and so you go through the portfolio asset-by-asset and you feed out into the market to the market what the greatest demand is at the current time.

But again, one of the consulting jobs we did on a large San Antonio S&L that was just taken over by the regulators this week, when we were studying a large land development deal that they were in, we stopped counting when we had assessed or identified 14,000 acres in San Antonio already fully developed, zoned, sewer, water, streets, utilities in, all you had to do is go get a building permit and build on it. And this was nonresidential. This was not for single family subdivisions. This was for apartments, hotels, office buildings and shopping centers. They could have tripled the amount of commercial space in San Antonio with the land that's already fully developed. Some of that land 15, 20, 30 years from now will still be vacant.

The CHAIRMAN. Let me just ask you one final related question for my part here. That is, in some of these so-called assistance agreements that were entered into in December it appears there are provisions that may provide an incentive to keep properties in an inventory bank for a long period of time, take fees, earn fees for sitting on those assets, which means the Government certainly will be doing one thing and that is they're going to be paying money out of pocket for that kind of supervision. They may also in that kind of a structured agreement create an incentive to not dispose of the asset when in fact maybe there's good reason to dispose of it.

Comment if you would on that.

Mr. GLEESON. I think it's a clear consensus in the marketplace down there that there is a lot of criticism of the yield maintenance fees. Again, you go back 2 or 3 years ago, there was tremendous pressure both from the industry, from the S&L industry, from banks, political pressure, don't dump the assets, don't do liquidating receiverships. Even if you have the money, don't do a liquidating receivership because we don't want all these assets dumped on the market and depress prices and we'll have a self-fulfilling prophecy of a really depressed market.

So the Bank Board in part of the Southwest plan factored in the fact that they did not want to dump these assets or be accused of dumping these assets, so they in effect paid the acquirers to hold them off the market with the offsetting balance being the rationalization, well, as the Texas market comes back and over a period of time, we should be able to recover some or most of these fees that we're paying to keep the properties off the market.

But again, if you take a piece of vacant land with the Texas cost of funds at 9 percent and a 250-basis point yield maintenance fee and ad valorem taxes, the property has got to appreciate 11 to 12 percent a year just to justify holding that property. And that is not a very likely assumption or a practical assumption to make for raw land.

Yes, some key pieces, but all the garbage we saw in these portfolios there's no way. Some of it will not have an appreciation factor for years.

The CHAIRMAN. Well, in those cases then we're crazy to pay somebody a fee to sit on it, aren't we?

Mr. GLEESON. Absolutely.

The CHAIRMAN. Do you agree with that, Mr. Selby?

Mr. SELBY. Yes, I do.

The CHAIRMAN. Senator Garn.

Senator GARN. I have nothing else.

The CHAIRMAN. Senator Bond.

Senator BOND. Nothing.

The CHAIRMAN. Gentlemen, thank you very much. It's late in the day. We may give you some questions to answer for the record, but we appreciate your patience and your candor and your testimony is very helpful to us.

The committee stands in recess.

[Whereupon, at 1:40 p.m., the hearing was adjourned.]

[Response to written questions of committee members follows:]

U.S. Department of Justice

Office of Legislative Affairs

HEARING OF FEBRUARY 9, 1989

Office of the Assistant Attorney General

Washington, D.C. 20530

MAR 29 1989

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Dear Mr. Chairman:

Thank you for your letter of February 15, 1989, to the Attorney General. This letter will respond to the questions enclosed with your letter. Each question, and our response, will be listed immediately below.

Question 1. The President, in his February 6 press conference announcing his program to resolve problems in the S & L industry stated that his administration:

> "will make every effort to recover assets diverted from S & L institutions and to place behind bars those who have caused losses through criminal behavior."

Mr. Selby, a witness on our second panel, claims in his prepared testimony that the cost of bailing out the insurance and attributable to fraud exceeds 50 percent of the total money needed. Do you agree with Mr. Selby? If not can you tell us how much of the cost of bailing out the S & L insurance fund you believe can be attributed to fraud by S & L operators, and how much of that amount you believe is recoverable?

Answer 1. Notwithstanding Mr. Selby's opinion, we believe that it is not possible to give the Committee a reliable percentage of the cost to the Federal Savings and Loan Insurance Corporation resulting from fraud. In our opinion, there is no means by which a reliable, useful percentage can be ascertained.

Question 2. Mr. Gleeson, who testified on our second panel, describes wide spread fraudulent activity in the Texas savings and loan industry. He further states that he and the other responsible real estate and financial service professionals throughout Texas "know that the perpetrators of these fraudulent activities are not being brought to justice."

Leaving aside the I-30 cases developed by the U.S. Attorney in Dallas, can you tell us how many convictions of Texas S & L fraudulent operators have been achieved by the Justice Department?

Answer 2. Attachment B to Assistant Attorney General Dennis' statement for the Committee of February 9, 1989, describes the convictions obtained by the Dallas Bank Fraud Task Force. In addition, the four United States Attorneys in Texas have been asked for their responses to your questions and we shall forward that information to you immediately after we have received it.

Question 3. Mr. Selby states in his prepared testimony that the Home Loan Bank Board sent 535 individual criminal referrals to the Justice Department in 1986 and that figure increased to 1,196 referrals in the year 1987 and that most concerned fraud in Texas thrifts.

Can you tell us why your Department has filed so few indictments in relation to the number of cases that have been referred?

Answer 3. There are various reasons why not all criminal referrals result in criminal prosecution. Included among those reasons are insufficient evidence of a crime, lack of sufficient investigatory or prosecutorial resources to pursue criminal prosecution, and insufficient time in which to investigate a referral prior to the expiration of the statute of limitations. The Administration's proposed legislation directly addresses the resource and statute of limitations obstacles to prosecution.

Question 4. Mr. Dennis on pages two and three of his prepared testimony gave rather incomplete answers to the first three questions posed by the Committee in its invitation letter to the Justice Department. How quickly will your Department be able to give us that information about how many insolvent or problem thrifts you have examined and in how many you have found fraud?

Answer 4. In his statement, Mr. Dennis explained that the Executive Office for United States Attorneys (EOUSA) collects and maintains statistics about the prosecutive activity of the United States Attorneys; the Fraud Section, as a service to the financial institution supervisory agencies, collects and maintains information about criminal referrals which the supervisory agencies have selected for tracking. Neither system contains statistics directly responsive to the questions contained in the Committee's letter of January 24, 1989; however, the EOUSA has asked each United States Attorney's Office to compile and send to the Department information for our use in preparing a full response to the Committee. We shall make our response promptly after we have received the information from the United States Attorneys.

Question 5. Mr. Dennis states on page 3 of your prepared testimony that:

> "according to F.B.I. statistics 7,385 bank fraud cases and embezzlement cases were pending at the end of September 1988."

In how many of those pending cases do you expect indictments to be brought?

Answer 5. We believe that it would be inappropriate for us to speculate about how many indictments might be brought by federal grand juries around the country; however, it may be helpful to the Committee to know that in Fiscal Year 1988, there were 2,197 bank fraud and embezzlement convictions and pretrial diversions, approximately $3 million in fines were imposed, and recoveries and restitutions totaled approximately $195 million.

Question 6. The acquittal last October of Thomas Merill Gaubert associated with now failed institutions in Texas and Iowa was a set-back to the Bank Fraud Task Force.

Was justice done in this case or did the prosecution miscalculate? What went wrong? Has the failure to win that case made it much more difficult to get pleas in other cases you are pursuing?

Answer 6. Thomas M. Gaubert was prosecuted following a determination by a federal grand jury that there was probable cause to believe that he had committed the offenses charged against him in the grand jury's indictment. After the presentation of evidence, both by the United States and Mr. Gaubert, a federal trial jury determined that the evidence was insufficient to prove beyond a reasonable doubt that Mr. Gaubert was guilty as charged and he was acquitted. The factors upon which the jury reached its determination are known only to the jury, whose deliberations, of course, were secret. We have no reason to doubt that the jury reached its verdict upon careful consideration of all the evidence admitted in the case; hence, it would appear that justice was done. Beyond that, we know of no miscalculation by the prosecution nor of anything that "went wrong." Lastly, the outcome of the case has had no discernible effect on our ability to negotiate pleas, nor should it.

Question 7. Has the Justice Department uncovered any evidence that organized crime was involved in looting the S & L industry?

Answer 7. An inquiry within the Justice Department is underway with a view towards collecting information responsive to this question. We will make a response to the Committee promptly after we have collected this information.

Question 8. Is it not true that, generally speaking, all bank employees and officers are covered by bonding insurance?

Answer 8. While we understand that generally such insurance may be required, we suggest that the financial institution supervisory agencies would be your best source of information regarding this question.

Question 9. When fraud is proven in, for example, loan arrangements made by a bank officer, not the borrower, does the banking institution involved generally seek payment from the bonding company, less any applicable deductible?

Answer 9. Please refer to the immediately preceding answer.

Question 10. As the FDIC takes over management of the troubled S & Ls, will you be aggressively pursuing all avenues of recovering losses including bonding insurance when fraud is proven to have taken place by bank employees?

Answer 10. The financial institution supervisory agencies routinely pursue losses when warranted and we have no reason to believe that they will do otherwise in the future. The Justice Department will support such efforts whenever the Department's support is needed and to the extent permitted by its resources.

Question 11. Have any estimates been made concerning how much may be recovered from bonding companies?

Answer 11. We have not made such an estimate nor do we know about such an estimate. We have substantial doubt that a reliable estimate could be made in the abstract as suggested by the question.

Question 12. In previous deals where failed S & Ls were taken over by new investors (such as the deals that occurred late last year), do you know if the government has been bound by any agreements not to look for and aggressively pursue cases of fraud?

Answer 12. We have no reason to believe that any such agreement has been made; if the Committee knows about any such agreement, please tell us.

If we may be of further assistance to the Committee, please tell me.

Sincerely,

Tm Boyd

Thomas M. Boyd
Assistant Attorney General

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM H. JOE SELBY

HEARING OF FEBRUARY 9, 1989

Q. 1. Mr. Gleeson in his prepared testimony states that much of the fraud that afflicted S + L's in Texas was made possible by an abdication of responsibility by the appraisal, accounting and legal professionals who dealt with the unscrupulous S + L operators. Do you think that charge has merit? If so do you think such professionals should be sued by the government to help obtain money to defray the cost of the insurance fund bail out?

A. 1. It is my opinion that the appraisal industry greatly facilitated the unscrupulous owners/managers of S + L's in Texas and other states in perpetrating fraud. A widely-known case example would be the use of "land flips" which could only be accomplished through the use of inflated and inaccurate appraisals.

I can recall that some members of the legal profession were found to have crossed the line in representing an S + L in Arkansas. Certainly, the accounting profession was not diligent in ascertaining the true condition of the financial institutions in the Southwest and in qualifying their opinions. I would mention that part of the problem seems to be the perception that appraisers, accountants, and attorneys are representing and paid by institutional clients and that their zeal to retain business oftentimes clouds their judgment. The government has, and should continue, to vigorously pursue through the judicial system of this country monetary claims for improper, imprudent and inaccurate discharge of fiduciary responsibility.

Q. 2. You state in your prepared testimony that prompt and decisive supervisory action can stop abusive mismanagement and fraud in a financial institution. You further state that the termination of insurance is one valuable supervisory tool that is seldom used because "the process of termination of insurance is laborious and time consuming."

Is that a tool that we should make it easier for regulators to use? If so what type of safeguards should accompany that grant of authority to regulators to assure honest banks and thrifts that it would not be arbitrarily exercised?

A. 2. The Federal Deposit Insurance Corporation routinely exercises the Termination of Insurance when the capital of an insured bank falls below 3%. The FSLIC never utilized that tool during my tenure with the Federal Home Loan Bank of Dallas. My suggestion for its use was based upon the premise that the very threat of its utilization would facilitate the supervisory process, particularly in the prompt and timely removal of incompetent and fraudulent management. The actual termination of insurance would probably never have to occur, nor would depositors have to be notified. I think that it is imperative that proper safeguards be built in, but I likewise think that the process might be streamlined to facilitate its more effective use by the regulators. Lawyers for the FSLIC will not allow its utilization because of the constrictions contained in the statute.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM
H. JOE SELBY

Q.1. You criticize certain accounting practices in your testimony, especially the practice of lending the full amount of principal, several years of interest, and certain loan fees in connection with real estate development deals. That permits a developer to use borrowed money to pay interest and loan fees before any revenue is generated by a development project. It also permits the S&L to book the return of the money just lent as "profit" that it can use to pay massive dividends to insiders. I have several questions: First, isn't it true that bank real estate loans are accounted for the same way? Second, should Congress put a stop to the practice for both thrifts and banks? Finally, should borrowers be required to guarantee repayment personally in addition to using the real estate collateral? Wouldn't that help curb speculative ventures while at the same time giving the institution and the insurance fund a better chance of recovery in the event of losses?

A. 1. I believe the question is really directed to Mr. Gleeson's testimony, but I will also attempt to answer the series of questions based upon my knowledge and belief. First, it is my belief that commercial banks follow the same accounting for fees as the S + L's. Secondly, the Congress in the International Banking Act passed in the late 1970's or early 1980's required upfront fees and interest on sovereign debt financed by the commercial banks to be taken into income over the life of the loan. It seems that an appropriate action for the Congress would be to extend that reasoning to real estate financing. Finally, the use of shell corporations and/or partnerships has resulted in the loss of a tremendous amount of money in financial institutions. While the problems points directly to mismanagement of a financial institution, certainly the principals should be required to cosign or guarantee the debt for the ultimate protection of the financial institution.

Q.2. Fraudulent real estate appraisals have been a big part of the thrift problem. How should statutes and regulations be changed to address this problem?

A. 2. The large problem of inaccurate and/or fraudulent appraisals seems to originate from the industry standards that exist, the lack of policing and/or subsequent punishment, and that the appraisals are paid for by the clients. I am unclear exactly how statutes and regulations could be amended or passed to alleviate the problem, but the best method, in my opinion, to prevent it in the future would be to actively pursue through the courts either criminal or civil penalties against the perpetrators of fraudulent appraisals.

Q.3. Should thrifts be more limited in all aspects of commercial real estate lending and investment?

A. 3. While I am not an avid supporter of regulations, such as those that were passed in the early 1930's, it does seem that having a base of statutes that would insure diversification in the asset portfolios of federally-insured financial institutions would do much to prevent a financial crisis of the magnitude that we now have in the future, and that limiting regulations would certainly protect the government's interest in its deposit funds. Commercial real estate lending and investment is high risk that should be protected by capital, supervision and possibly tighter regulation. If risk-based capital standards and requirements were truly in effect and followed, limiting statutues would be unnecessary.

Q.4. In light of the extent of real estate development investments as a cause of the present problem, do you believe that such investments should be totally banned for federal insured depository institutions, or that a certain level of such investments should be permitted, but subject to closer scrutiny and supervision?

A. 4. Financially-related powers should be accorded to all financial institutions. Real estate and real estate development certainly is a related activity in my opinion, therefore I do not think it should be prohibited. I likewise feel, however, that it requires a high degree of scrutiny. From my experience as a regulator, I would like to think that a higher level of supervision can negate harmful effects from such investments. However, a high degree of expertise in such activity is not presently available in either the banking or thrift regulators or, if it is, it is very spotty. This would probably also apply to any of the new powers that banks or thrifts engage in. To rely upon the regulators will require more emphasis on specialization, training, compensation and recruitment.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR KASSEBAUM FROM
H. JOE SELBY

Q. 1. On Tuesday, Paul Volker suggested that brokered deposits substantially contributed to the ability of some of the most highflying and fraudulent institutions to attract money. Did you find this to be the case in the institutions you examined? Do you think the money brokers had any idea about the management or institutions into which they were putting their clients money?

A. 1. The availability of deposits to managers of financial institutions in Texas and the Southwest, including the use of brokered deposits, certainly facilitated the unrestrained lending that occurred, which in itself fueled the false economy of Texas. The money brokers did not really care about the management nor condition of the financial institutions to which they directed their clients' money as long as they were protected by federal deposit insurance. I believe the case for restricting money brokers was well documented by Chairman Ed Gray of the FHLBB and Chairman Bill Isaac of the FDIC in their attempts to convince the Congress of the need for restrictive legislation.

Q. 2. Because of its inherent nature, can substantial commercial real estate lending and development be effectively regulated?

A. 2. Commercial real estate lending and development by its very nature is high risk. It can be controlled by a variety of methods. First, legislation could be passed which would effectively limit the amount of such investment in a financial institution's portfolio of assets ("diversification" or "don't put all your eggs in one basket"). This was done after the Depression in the early 1930's and remained in the banking industry well into the 1960's. The only problem with such limiting legislation is that it applies to all institutions, including the well-managed. It also has a tendency to prohibit things that change rapidly, penalizing the financial services industry and rewarding non-insured competitors, and it creates loopholes that are found by the enterprising institutions. Secondly, effective risk-based capital standards could be developed and strenuously applied which would in themselves confine the risk of such activities to acceptable levels. Finally, the supervisory process at the federal level could be enhanced so that such risk could be more effectively monitored i.e. better compensation, better recruitment, specialization, dedicated programs of examination and supervision, etc.

Q. 3. Although some state chartered thrifts can devote 100 percent of their assets to commercial real estate loans, federally chartered thrifts can devote no more than 40 percent of their assets to such loans. Did you find instances of fraud in federally chartered thrifts as well?

A. 3. Federally-chartered thrifts were not immune to fraudulent activities of its ownership/management.

HEARING OF FEBRUARY 9, 1989

RESPONSE TO QUESTIONS FROM THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE TO TESTIMONY GIVEN FEBRUARY 9, 1989

S & L FRAUD

BY: DAVID W. GLEESON

Responses to questions by Senator Donald W. Riegle, Jr.:

Q. Do you believe that Mr. Selby's estimate that losses in S & L's attributable to fraud "perhaps exceeding 50%" are realistic?

A. With the utmost respect for Mr. Selby's estimate, I do believe that amount could be excessive. That could partly be due to the difference in definition. I am tending to confine my application of fraud in a more narrow range that I define as "indictable" fraud. On the other hand, I believe that Mr. Selby is using a broader application that includes blatant conflicts-of-interest and other borderline activities.

Also, please keep in mind that when Mr. Selby came to the Ninth District the situation was in utter chaos. He probably tended to focus on the worst of the worst and this could possibly have biased his assessment. It is also possible that Mr. Selby applied stricter guidelines and standards applied under the Office of the Comptroller of the Currency that tend to be much more explicit than what has existed in the Federal Home Loan Bank examination and supervisory area.

I do believe that the estimate is on the high side in light of my qualifying statements above. I would be inclined to follow a more conservative estimate along the lines given by the U.S. Attorney General, 25-30%.

RESPONSE TO QUESTIONS FROM THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE TO TESTIMONY GIVEN FEBRUARY 9, 1989

S & L FRAUD

BY: DAVID W. GLEESON

Responses to questions by Senator Jake Garn:

Q.#1 How did pre-1986 tax laws benefit multi-family housing and thereby distort the pricing system of apartments in the marketplace?

A. The 15 year depreciation afforded apartments was a major component of providing non-cash tax losses. The second component was being able to deduct almost limitless interest deductions. The third element was the ability to deduct on a current basis interest that was accrued to actually be paid at a later date. The result was that investors were able to invest, say $1,000,000 in cash as a down payment on a $10,000,000 acquisition and split-fund the $1,000,000 payment over three years. During that period of time the investor received $1.5 - $2 million dollars in tax losses over that three year period. This often meant that investors in a 50% marginal tax bracket looked solely at the tax benefits generated by the investment and almost totally disregarded cash returns and investment yields. In some extreme cases, investors were paying so much for apartments and placing so much debt on them that they were having to feed negative cash flows for 5-6 years just to get the tax benefits. This was happening well after hyper inflation was abating and the hard asset investment was on the wane.

The 1986 tax laws more than off-set these previous benefits and probably over-compensated. However, for the first time in my 20 year career investors are now talking about acquiring apartments based on the over-all capitalization rate, and internal rates of return. In other words, they are now totally yield oriented and tax benefits are little. This is also one of the reasons that most investors cannot justify hanging on to marginal properties.

Q. #2. Should the examination and supervisory functions for thrifts be under the Federal Home Loan Bank System?

A. What I was trying to say in my testimony was that I approved of the fact that Ed Gray permitted the examination teams to move from Washington to the District Bank locations in order to provide an opportunity for them to receive higher compensation and attract more qualified people. They could also be closer to the institutions they examine. I am in total concurrence that the S & L's be examined by a totally independent organization, such as the Office of the Comptroller of the Currency for banks. There is absolutely no doubt in my mind that the industry controlled District Banks and Texas Saving & Loan Department were part of the problem in addressing these problems at the early stages. I give Ed Gray, Joe Selby and Walter Faulk most all of the credit for defying the industry influence and political pressure and taking control of the situation.

Q. #3. Should federal insured depository institutions be banned from commercial real estate lending, or should their level of investments simply be subject to closer scrutiny and supervision?

A. Over the years and through various regional and national economic recessions, banks have done an admirable job in making commercial real estate loans. The traditional lending pattern had been for the banks to make a construction loan, while the life insurance companies or pension funds provide a take-out commitment for funding of permanent long-term financing. There are many reasons why the banks have been much more successful at commercial lending than the S & L's. Simply put, the banks have earned their stripes in the trenches of making their own fair share of mistakes over the past 20-30 years. But, they are also under much tougher regulation and supervision.

Banks definitely should be able to continue their role in commercial lending although I believe we will begin to see more real estate losses go on the books of big banks in other regions of the country as they also get over-built. Making open-ended construction loans with no take-out is fairly risky. Banks and S & L's should not be permitted to make direct investments in real estate as an investment.

I do believe that most S & L's still have yet to prove their ability to properly underwrite commercial real estate loans. They should be severely limited in making loans on raw land or for land development projects. They should not be permitted to include accrued interest in those loans and the loans should be for less than 100% of cost, regardless of the appraised value. By far the greatest losses in S & L's in this region will be from their imprudent land loans and investments. They should definately be prohibited from investing more than 3-4% in land, if anything at all.

Q. #4. How should statutes and regulations regarding real estate appraisals be changed so that they can be more reliable and less abusive?

A. It is my understanding that eight of the leading organizations that issue appraisal designations are working closely with Congressman Barnard's subcommittee and the OMB on new legislation that will require state licensing of all appraisers who provide any type of appraisal service. In addition, the appraisers can choose to be certified or non-certified by the state. Certification would be required for all appraisers doing appraisal work on loans to institutions with federal deposit insurance or to Fannie Mae, Freddie Mac, FHA or VA. Certification standards would be set by federal guidelines. The legislation being proposed would mandate states to set up this licensing and certification procedure and a regulatory system. This concerted effort by the appraisal organizations is long overdue and I believe this legislation should be pushed along with an overall package of new thrift and banking legislation. The legislation should also prohibit any appraisers from being "grandfathered" and exempted from licensing or certification. It should also be tight enough to provide some accountability to the appraisers for the quality of their work. However, in the final analysis, management and federal examiners should not be able to hide behind the existence of a supportive appraisal as an excuse for over-looking imprudent and irresponsible lending.

Q.#5. "Should thrifts be more limited in all aspects of commercial real estate lending and investment?"

A. I believe most of this has been covered in the answer to question #3 above. I believe that pension funds are going to continue to play a greater role in lending for commercial real estate. They have a much lower effective cost of funds and can afford to have the kind of long-term perspective required in commercial real estate lending and investing. There are a lot of highly qualified firms giving advice and counsel to pension funds on their real estate portfolios. It is interesting that most of the thrifts did not choose to use experienced real estate advisors on selecting commercial real estate loans and investments. Instead, they chose to simply convert single family lenders to commercial lenders and apparently expected them to have intuitive knowledge on making commercial loans. I do not see any adverse impact to the real estate market if S & L's are severely limited in their commercial lending activity. If they are limited in their lending on land loans that means that they end up in direct competition with life insurance companies and pension funds for improved commercial developments. Since they typically have the highest cost of funds they are forced to go to second and third tier developers with commensurate type projects. This increases their risk and, therefore, raises the question of whether or not these projects should even be developed. This is exactly what happened in many of the loans we reviewed.

HEARING OF FEBRUARY 9, 1989

RESPONSE TO QUESTIONS FROM THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE TO TESTIMONY GIVEN FEBRUARY 9, 1989

S & L FRAUD

BY: DAVID W. GLEESON

Responses to questions from Senator Nancy Landon Kassebaum.

Q. #1. Do you think that brokered deposits played a key role in the ability of the "high-flying" S & L's to attract deposits and do you think that the brokers had any knowledge of the level of mismanagement of these institutions?

A. There is no doubt that brokered deposits were a key component in permitting the wildly excessive growth of many S & L's. In the text of my testimony I state that the total asset base of thrifts in Texas grew from $42 billion in 1982 to $96 billion in 1986. I would venture to say that a substantial portion of this growth came through brokered deposits from outside of Texas.

I would assume that most institutions that were involved in placing brokered deposits in these various thrifts did some type of due diligence on the stated net worth and earnings of these thrifts. However, it is obvious that the S & L auditors were not much help in reflecting the true condition of these institutions. One major Wall Street firm is currently recommending buying CD's in a major California thrift where 30 to 35% of their total assets are in junk bonds. I wonder how much time they have spent analyzing this junk bond portfolio and assessing inherent risks in the safety and soundness of that institution.

Q.#2. Can commercial real estate lending and development be effectively regulated?

A. Below are the answers of similar questions previously asked from Senator Garn.

Answer to Garn Question #3. Over the years and through various regional and national economic recessions, banks have done an admirable job in making commercial real estate loans. The traditional lending pattern had been for the banks to make a construction loan, while the life insurance companies or pension funds provide a take-out commitment for funding of permanent long-term financing. There are many reasons why the banks have been much more successful at commercial lending than the S & L's. Simply put, the banks have earned their stripes in the trenches of making their own fair share of mistakes over the past 20-30 years. But, they are also under much tougher regulation and supervision.

Banks definitely should be able to continue their role in commercial lending although I believe we will begin to see more real estate losses go on the books of big banks in other regions of the country as they also get over-built. Making open-ended construction loans with no take-out is fairly risky. Banks and S & L's should not be permitted to make direct investments in real estate as an investment.

I do believe that most S & L's still have yet to prove their ability to properly underwrite commercial real estate loans. They should be severely limited in making loans on raw land or for land development projects. They should not be permitted to include accrued interest in those loans and the loans should be for less than 100% of cost, regardless of the appraised value. By far the greatest losses in S & L's in this region will be from their imprudent land loans and investments. They should definately be prohibited from investing more than 3-4% in land, if anything at all.

Answer to Garn Question #5. I believe most of this has been covered in the answer to question #3 above. I believe that pension funds are going to continue to play a greater role in lending for commercial real estate. They have a much lower effective cost of funds and can afford to have the kind of long-term perspective required in commercial real estate lending and investing. There are a lot of highly qualified firms giving advice and counsel to pension funds on their real estate portfolios. It is interesting that most of the thrifts did not choose to use experienced real estate advisors on selecting commercial real estate loans and investments. Instead, they chose to simply convert single family lenders to commercial lenders and apparently expected them to have intuitive knowledge on making commercial loans. I do not see any adverse impact to the real estate market if S & L's are severely limited in their commercial lending activity. If they are limited in their lending on land loans that means that they end up in direct competition with life insurance companies and pension funds for improved commercial developments. Since they typically have the highest cost of funds they are forced to go to second and third tier developers with commensurate type projects. This increases their risk and, therefore, raises the question of whether or not these projects should even be developed. This is exactly what happened in many of the loans we reviewed.

Q. #3. Did you find instances of fraud in federally chartered thrifts as well?

A. With only one exception, all of the institutions in which we did consulting and had first hand access to files on specific transactions were all state chartered thrifts. The only exception was a federally chartered thrift that is one of the largest in Kansas.

In many instances, there is an extremely fine line between fraud, conflicts-of-interest and imprudence. But, at some point you would think that a high level of imprudence and incompetence that results in substantial losses and the squandering of financial assets could certainly be considered fraudulent. I do not believe that federally chartered thrifts are exempt from abuse or fraud, but I believe that you will find that the worst cases and the greatest volume of problems is state chartered thrifts around the country.

Federal Home Loan Bank Board
OFFICE OF THE CHAIRMAN

M. DANNY WALL, Chairman

1700 G Street, N.W.
Washington, D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

25 MAY 1989

Honorable Donald W. Riegle
Chairman
Senate Committee on Banking, Housing and Urban Affairs
534 Dirksen Office Building
Washington, DC 20510

Dear Senator Riegle:

Attached is a copy of the Federal Home Loan Bank Board/Federal Savings and Loan Insurance Corporation's response to Lowell Bryan's testimony before the Senate Committee on Banking, Housing and Urban Affairs.

This response addresses the assertions contained in Mr. Bryan's testimony and will serve to further highlight the purposes and objectives of the Southwest Plan. Additionally, the response contains answers to the Committee Member's inquiries.

I would be grateful if this document was inserted at the appropriate place in the Record of the January 31, 1989 hearing.

Sincerely,

M. Danny Wall
Chairman

Attachment

A. General Responses

Specific responses to Mr. Bryan's critique of the Southwest Plan contained in his January 31, 1989 testimony to the Senate Committee on Banking, Housing and Urban Affairs are provided below. However, a few general comments are in order to ensure that these responses and Mr. Bryan's critique are viewed in the proper context. Mr. Bryan's assertions evince a misunderstanding of the purposes and objectives of the Southwest Plan, a lack of understanding about business transactions, and a certain naivete with regard to economic reality. Such flaws in Mr. Bryan's analysis are to be expected since he neither sought to, nor interviewed any member of the Southwest Plan staff. Therefore, the litany of erroneous assertions contained in his testimony are unsubstantiated by the facts.

(1) Misunderstanding of the Southwest Plan

Mr. Bryan claims that all Southwest Plan transactions were tax based. This assertion is wrong. As articulated below, only 4 of the 15 Southwest Plan transactions were tax driven.

Contrary to Mr. Bryan's assertions, the deals do not "guarant[y] the involved parties with a guaranteed return plus the opportunity for all upside profit." No Southwest Plan Agreement contains any provision regarding guaranteed returns. Further, the FSLIC keeps a large percentage (typically 80% to 90%) of the profits generated from covered asset sales. Finally, the FSLIC typically receives 20% or more of the dividends paid by the institution as well as a 20% (in most transactions) ownership position reflected in the warrants the FSLIC holds.

Mr. Bryan contends that the Southwest Plan does nothing to address the "overcapacity plaguing the industry." The Southwest Plan was specifically designed to eliminate overcapacity. The Plan has reduced the number of thrift institutions from 279 in March of 1988 to 204 institutions as of March 1989. Moreover, 240 branches have been closed and the liabilities of these institutions have been substantially diminished. Even a casual observer of the Plan would have noticed this trend. Finally, the institutions created as a result of the Southwest Plan are required to shrink their liability base as they go forward. Therefore, the losers are disappearing.

Mr. Bryan is concerned that more and more thrifts will slide into insolvency as a result of the Southwest Plan. In fact, if a course of liquidation was pursued in Texas, the asset values of marginally solvent thrifts and banks would become further depressed and they would slide into insolvency as the value of their portfolios was written down. Marginally solvent institutions in Texas have reason to fear the adverse impact of mass liquidation more than competition with Southwest Plan institutions whose activities are closely monitored by the FSLIC and the Federal Home Loan Bank of Dallas.

(2) Lack of Understanding about Business Transactions in General and FSLIC-Assisted Transactions in Particular

Mr. Bryan suggests that providing certain indemnifications to buyers, such as guaranteeing "legal fees for any challenge to these deals" is unusual. Such an indemnification is not unusual in the field of mergers and acquisitions especially when the buyer has had limited opportunities to perform due diligence. Typically, the seller provides indemnifications to the purchaser with regard to any undisclosed liabilities.

Mr. Bryan states that the FSLIC is absorbing all the risk in these transactions. This statement is erroneous because the FSLIC neither absorbs any of the risk on uncovered assets nor any of the risk on new loans.

Mr. Bryan is concerned that these institutions have an advantage in acquiring other institutions. First, further acquisitions require Bank Board approval and then only after the bidding process has been completed. Second, FSLIC-assisted institutions are in no better a position to make further acquisitions than FDIC-assisted institutions. Third, if further acquisitions eliminate the overcapacity plaguing the industry, then Mr. Bryan should be pleased.

Mr. Bryan characterizes the transactions as sweetheart deals. From his vantage point such a mischaracterization is understandable since, by his own admission, he lacks complete information regarding these transactions. Further, Mr. Bryan has never participated in a Southwest Plan negotiation and therefore lacks any knowledge of the policies, processes, procedures, terms or conditions relevant to these transactions.

Mr. Bryan also complains about the identity of the Southwest Plan acquirors: "It is no wonder that the richest, smartest, most aggressive deal-doers in the country went after these deals." This assertion reveals Mr. Bryan's lack of understanding about the acquirors. First, attracting Fortune 500 companies to acquire institutions in the Southwest Plan was complicated due to legal and economic impediments. Potential large publicly traded companies had qualms about the regulatory restraints imposed by the laws governing the operation of a thrift or a thrift holding company on their other lines of business. The economic constraints centered on the credit-worthiness of FSLIC notes and FSLIC-backed obligations. Further, the directors of large publicly held companies were keenly aware of their duties to their shareholders and the risks associated with FSLIC credit-worthiness and therefore were unwilling to expose the company to such possible risks. Such concerns will only mount if talk of unwinding these transactions continues. Further, potential Fortune 500 acquirors were influenced by the negative publicity surrounding the FSLIC. Constant pronouncements that the payment of these funds are due and owing from an insurance fund that the GAO characterizes as insolvent combined with statements made by certain government officials and industry leaders contending that full faith and credit should not be extended to FSLIC obligations does nothing to alleviate these concerns.

(3) A Naivete With Regards to Economic Reality

Mr. Bryan's critique is internally inconsistent. He contends that by liquidating thrifts and shifting their deposits, sick institutions will be transformed into healthy ones. Ultimately, these deposits will have to be backed by earning assets, and he offers no guidance as to the source of these assets. Mr. Bryan's proposal implies that the Bank Board should turn over these deposits to marginal institutions and rely on the judgment of managers who have led them to near insolvency to make good loans.

Mr. Bryan also argues that winners should win and losers should disappear. In Texas, this would result in the virtual elimination of the entire thrift industry. Further, such a bold statement, if carried out, would have precluded the execution of FDIC-assisted transactions in Texas.

Further, Mr. Bryan claims that the Southwest Plan is socially undesirable because it makes rich men richer. This is a totally specious argument in light of Mr. Bryan's suggested alternative - liquidation. Mr. Bryan seems to suggest that under a liquidation scenario that either rich men will not get richer or that somehow poor men will get richer. In a liquidation scenario, the liquidator (most likely a government agency or an employee of the government) will sell to those offering the best price. In past liquidations, these individuals tend to be real estate speculators, individuals with large sums of cash or individuals who have access to large sums of cash. Thus, the liquidation mode does not ensure a better "social" result than the Southwest Plan.

Mr. Bryan also ignores the fact that there is little risk in purchasing assets at fire sale prices from the government. Mr. Bryan fails to offer guidance with regard to the costs of managing and disposing of these assets and how these costs would affect the liquidation numbers with regard to Texas. Further, it will be virtually impossible to monitor the activities of these asset managers whether they are government employees or contractors to ensure they are receiving the best price. By contrast, Southwest Plan acquirors have economic incentives to acquire the best price for the FSLIC. Under a liquidation scenario, the FSLIC gets none of the upside and bears all of the downside anyway.

Liquidation and the dumping that may ensue has detrimental impacts on society. Initially, it results in massive layoffs and the attendant social dislocations resulting from unemployment. To the extent that mortgage payments represent a form of forced savings or homeowner's equity, the liquidation of housing assets will further depress the value of residential properties in Texas and thereby result in a penalty for those who have been forced to save or by a reduction in the equity in their homes.

Finally, Southwest Plan institutions have been instructed to refinance mortgages that are above market rates to the benefit of homeowners.

B. Specific Responses

(1) The use of tax benefits in Southwest Plan Transactions

Mr. Bryan criticizes the use of tax benefits as an instrument for negotiation and assumes that the FSLIC absorbs all the risk in the transactions.

First, the Southwest Plan transactions have been erroneously portrayed in Mr. Bryan's testimony as tax-driven. Of the 15 Southwest Plan transactions executed to date, only the Temple-Inland, McAndrews Forbes, Pulte Home and Centex acquisitions can be characterized as tax driven. Even in these transactions, the acquirors have offered management expertise and/or synergisms which will provide for a healthier thrift industry in Texas. They have also demonstrated a commitment to satisfying all the goals of the Southwest Plan in addition to being the lowest cost bidders.

The cost of tax benefits in all FSLIC-assisted transactions, including Southwest Plan resolutions, have a de minimis cost to the Treasury when compared with the impact of leveraged takeovers (both friendly and hostile). For example, in the RJR-Nabisco leveraged takeover, the federal government is providing a $5 billion subsidy to the acquirors through the tax treatment of corporate debt. The RJR-Nabisco acquirors retain 100% of these tax benefits; by contrast, in FSLIC-assisted transactions, the FSLIC recaptures a percentage, if not all, of the tax benefits available to acquirors.

Mr. Bryan's focus on tax benefits in Southwest Plan transactions fails to realize that this "subsidy" has also been widely used by the FDIC. For example, Southwest Plan transactions become easily defensible when a comparison is made with the FDIC assisted NCNB transaction. According to FDIC estimates, NCNB can realize up to $1.4 billion in tax breaks. In the FDIC's analysis, it noted that the efficient use of these tax benefits made NCNB a superior bidder since it lowered the cost of solution when compared with competing bidders.

Additionally, it should be publicized that the acquirors must satisfy constantly rising capital adequacy standards. The recycling of tax benefits can be a primary source of this increased capital funding. Due to FSLIC's equity position in each transaction, FSLIC receives 20% of the benefit of this additional capital funding at no additional expense. In a sense, FSLIC is already obligated to bear the costs of the resolution of the Texas insolvents whether or not FSLIC pursues a liquidation or a Southwest Plan transaction. Therefore, FSLIC may recapture through future increases to the capital base of a Southwest Plan thrift up to 20% of these recycled tax benefits in addition to straight tax sharing arrangements provided in the Assistance Agreements. Tax benefits may also contribute to the viability of the ongoing institution and thereby increase the value of the warrants FSLIC holds.

Furthermore, the usage of tax benefits and the issues associated with these transactions have been grossly misunderstood and misrepresented by the press. Acquirors which place significant amounts of initial capital ($50 - $315 million) in relation to their overall corporate structure are anxious to seek a method of ensuring the minimal exposure of this capital. This motivation compels them to seek a method of earning an amount equal to their initial capital infusion as soon as possible. Their economic motive for this return, their concern about their ability to realize a return on their investment and their concerns about the probability of realizing such a return are not unfounded. If FSLIC fails to satisfy its obligations under the Assistance Agreements, then the acquirors' capital is placed in peril. Acquirors are vividly aware that neither the principal nor interest nor yield maintenance (all FSLIC obligations) are guaranteed, which also explains why only the "most aggressive deal-doers" as Bryan's testimony states, were attracted to the Plan.

Thus, the tax benefits are a partial risk management tool that may be employed as a type of government subsidy provided by the Treasury if another government agency, the FSLIC, fails to satisfy its obligations to pay the subsidies (yield maintenance, loss coverage, interest payments) it owes the acquirors. If the doubt associated with regard to the payment of the subsidy represented by FSLIC obligations can be extinguished, then the FSLIC's negotiating position with regard to the retention of a greater percentage, if not all, of the tax benefits will be greatly strengthened. Already, the lack of the full faith and credit by Congress has, without doubt, caused the withdrawal of several publicly traded and privately held companies as potential acquirors. It is also true that once FSLIC notes are guaranteed, then more Fortune 500 and other publicly traded companies will be willing to participate in the Plan.

(2) Southwest Plan Transactions are not risk free.

Mr. Bryan's testimony states that the FSLIC assumes all risk in Southwest Plan transactions. This assertion is erroneous. Obviously Mr. Bryan does not recognize that all operating costs of the institutions must be met by the new investor, which can be between one and two percent of assets for a healthy institution, and therefore absorb a substantial part of the yield maintenance payment.

Furthermore, he fails to consider any of the inherent operating risks and management costs associated with thrift consolidation. For example, some of the costs in the management of a troubled portfolio can include: property management fees; litigation management expenses; fees paid to consultants for the development of work plans; the costs associated with fully separate detailed accounting and control systems for such assets; the expenses attendant to heavy internal staff time to control and work out assets; and the cost related to the substantial internal and external time in fulfilling FHLBB/FSLIC reporting requirements. Additionally, management must consolidate the various computer and operational control systems among the different branches of new thrift institutions. New management must not only shoulder these responsibilities, but also generate new assets within a tattered marketplace. The risk associated with these assets is borne entirely by the acquirors.

Finally, under current laws and regulations, the Federal Home Loan Bank Board can "close" institutions only upon a finding of insolvency. In essence, the Bank Board must wait until an actual bankruptcy occurs before it can take definitive action. By contrast, in Southwest Plan transactions, prenuptial agreements are entered into with acquirers. These prenuptial agreements permit the FSLIC to take possession of an institution while it still has positive net worth. Therefore, a Southwest plan investor may have a substantial portion of his capital confiscated by the FSLIC.

(3) The Southwest Plan creates a competitive environment for all solvent institutions.

The testimony also states that the Southwest Plan is competitively unfair by creating " a new class of essentially tax-free institutions" which have enormous advantages in the market place. Again, reality indicates the situation in Texas to be contrary to Mr. Bryan's claims. For example, one of the most important goals of the Southwest Plan is to lower the Texas premium. One threat to attaining this objective on a timely basis is NCNB-Texas. Southwest Plan acquirors, solvent thrifts operators, and commercial bankers in Texas have been unanimous in expressing their anxieties about the impact of the rates NCNB-Texas (and more recently M-Corp) are paying for funds. Currently NCNB-Texas is one of the highest rate payers in the state and in certain geographic areas, the highest rate payer. Due to its asset size and statewide branch network, NCNB-Texas is in direct competition with every Southwest Plan created thrift and every solvent and insolvent thrift yet to be addressed by the Plan.

Thus, the proper focus of Mr. Bryan's concerns should be on the ability of all solvent thrifts, regardless of FSLIC assistance, and all solvent commercial banks to compete with FDIC-assisted behemoths such as NCNB-Texas and First City BancCorp. NCNB-Texas has run television and print advertisements boasting of their high yield CD's and the number of responses they have received. Since little doubt exists as to the adverse impact of brokered CD's and hot money on the thrift industry in general and their devastating effect in Texas, NCNB-Texas, and its 51% shareholder, the FDIC (initially the FDIC held 80% of NCNB-Texas stock), are exacerbating existing problems. The market-share of NCNB when combined with the recently implemented conservatorships, have not furthered and have probably impeded the Southwest Plan's goal of lowering the Texas premium.

Initially NCNB-Texas offered high yield CD's because of the liquidity crisis arising from the Republic Bank/Interfirst transaction, this crisis should be addressed by the Federal Reserve Bank of Dallas and the FDIC. At present, NCNB-Texas has been allowed to address the liquidity crisis resulting from the acquisition of Republic Bank/Interfirst at the expense of the Southwest Plan acquirors and the FSLIC. The FSLIC's overall cost of resolution in Texas will drop as the Texas cost of funds drops since the interest payments on the note and yield maintenance payments are based on the Texas cost of funds. By raising the cost of funds in Texas, NCNB-Texas contributes substantially to the increased costs of resolution in Texas. Further, NCNB-Texas receives carrying costs on assets held in its bad bank and these carrying costs are based on the institution's internal cost of funds. Thus, NCNB-Texas has no real incentive to reduce its cost of funds and causes other institutions to raise their cost of funds to compete with NCNB-Texas.

(4) Liquidation alone is not the proper response to the thrift crisis in Texas.

Perhaps the most ill advised recommendation provided by Mr. Bryan is his call for liquidation. Simply stated, liquidation is not a viable alternative because the costs of liquidation exceed the costs of resolution in all Southwest Plan cases. Further, the liquidation of 75-80% of the assets of insolvent Texas thrifts will do no more than ensure a further decline in the value of real estate assets throughout the state, resulting in the unnecessary failure of additional commercial banks and thrift institutions, and will delay the economic recovery of the 10th largest economy in the world by contracting the supply of available liquidity.

Those arguing for immediate liquidation also fail to consider the statewide impact caused by wholesale S&L liquidations. The Texas state budget is financed primarily through property, not income or sales taxes. Therefore, immediate liquidation has a potentially devastating effect on the state budget as property values stagnate or decline further due to dumping. Further, liquidation will not only increase the numbers on welfare rolls, but also will be accompanied by a corresponding decrease in the number of individuals currently paying taxes. Thus, the costs associated with liquidation become immeasurable as they increase vertically and horizontally to ultimately affect millions--not just thrift depositors, owners or operators.

The only beneficiaries of an immediate liquidation are real estate speculators who would buy at the bottom and hold until a profit is realized. Not even the critics of the Plan can demonstrate a need to put these properties on the market for sale or development since the market is presently flooded with unsold, unleased or partially completed residential and commercial buildings.

The most obvious reason to avoid liquidation is the staggering expense required to obtain, manage and dispose of the troubled assets within a vast federal bureaucracy. Congress established the FSLIC with specific authority and powers to protect the depositors. With that perspective, the Southwest Plan provides profit sharing incentives to new, experienced investors to manage asset disposition more efficiently and thus retain the depositor's value. This approach is demonstrably less expensive than using a federal institution where financial incentives are unavailable, expertise and on site decision-makers are lacking, and costs would skyrocket. For example, the acquirors of United

Savings of Texas have successfully disposed of a $2 billion mortgage-backed securities portfolio since its December 30, 1988 acquisition. The FSLIC realized $14 million of the $16 million in profit gained from these sales.

C. Answers to Committee Member's inquiries

Question: Was there competitive bidding for the Southwest Plan?

Yes.

Prior to the commencement of the "operational stage" of the Southwest Plan, a study was made that divided the state of Texas into 14 geographic regions. Initially, the Plan called for the consolidation of 100 institutions into 28 thrift groups. The Southwest Plan is designed to generate the maximum geographic, as well as financial benefits to the Texas thrift industry. The bid process is designed to ensure short term market efficiency (by reducing the supply of thrifts and thus lowering operating costs), while still maintaining a firm level of competition.

The Plan groups the thrifts into packages according to levels of insolvency, location of branches and location of troubled assets, size, and functional capabilities. The packages are categorized into three types of consolidations: local, regional, and multi-regional. They were developed months in advance of the bidding process by a thrift industry consultant under contract to the Bank Board. The groupings were developed with the aid of a computer model that identified economic efficiencies of each region (private consultants confirmed the efficiency of the groupings as well).

The packages have been given code names to avoid disclosure until after the proposals are reviewed. The Southwest Plan resolutions executed to date have varied little from the original plan. Modifications to the original plan are initiated by the Southwest Plan staff in consultation with the plan's original designer. Any other modifications are approved by the Bank Board prior to the final resolution.

The bid process is designed to be free of undue political influence. The policies and procedures relevant to the bid process are designed to ensure that the FSLIC receives the best offer from a suitable bidder without any regard to political affiliation. Efforts have been made to ensure minority participation in the bid process and in the operation of Southwest Plan institutions.

Furthermore, the Southwest Plan is open and equitable to all suitable bidders. However, because of the quantity and identity of the bidders for an institution or institutions contained in a specific grouping, the showing of an entire grouping to all potential bidders would be totally impractical. For example, many of the potential bidders are insolvent or marginally solvent institutions with weak management. Other bidders frequently do not have sufficient capital to bid on the entire package. (Often, attempts are made to accommodate these bidders with outside sources of capital, if the Dallas Bank finds them to be suitable bidders). Unless such circumstances arise, undercapitalized potential bidders have no need to be shown the entire package.

Before any specific bid on a Southwest Plan grouping is taken to the Board, all suitable bidders for that package are given an opportunity to bid on that package. Thus, a two-step suitability determination is made with regard to all Southwest Plan transactions. After consultation with the lead negotiator, the Dallas Bank, and, in certain cases, the Texas S&L Commissioner, a determination is made as to whether the bidder is suitable to operate the amassed size of the new institutions. Having passed this test, determinations are then made regarding whether a bidder is suitable for the package under consideration. The investors then bid on the packages or packages as they are grouped and the competitive bidding process is allowed to follow its natural course.

To avoid any misunderstanding, a brief illustration is provided below.

Step 1: After an initial review has been passed, each bidder's proposal is assigned to the relevant grouping or groupings as contemplated by the Gravette study.

Step 2: Bidder X bid on institutions 1,2,3,4, and 5; under the Southwest Plan, institutions 1 and 2 are in the Dog package and institutions 3, 4 and 5 are in the Cat package.

Step 3: Bidder X's proposal will be reviewed with all other proposals concerning institutions in the Dog and Cat thrift groups.

Step 4: If Bidder X is found to be a suitable bidder,then a determination is made to decide whether Bidder X is a suitable bidder for the Dog and Cat packages. If X is a suitable bidder, then it will be given a chance to review the entire Dog And Cat bid packages. Suitability for a particular package is viewed liberally to encourage

> more competitive bid situations, while the determination or finding that a bidder is a suitable bidder for the purpose of the Southwest Plan is only made after rigorous review. Therefore, a two-step process: First, is the bidder suitable? Second, for what package is this bidder suitable?

This bid process has been conducted successfully throughout the Southwest Plan transactions. As potentially suitable bidders prepare to enter the bid process, efforts are made to assign them to all the packages on which they may appropriately bid. If any criticism can be leveled against the Plan, it would focus on this part of the bid process as being overly inclusive with regard to the thrift groupings. However, the Plan followed these guidelines to ensure that the bid process is equitable to all.

Once the suitable bidders for a specific package have been identified, they are required to submit an initial term sheet which is analyzed by the FSLIC/Southwest Plan staff. Each bidder is then invited to a meeting where the specifics of the bidder's terms and conditions are discussed to eliminate any ambiguities with regard to the bid or inform the bidder of any provisions in the bid that are unacceptable to the FSLIC or The Federal Home Loan Bank Board. The bidder is then permitted to submit a "best, last" bid.

These bids are then costed by the FSLIC staff to determine which bid offers the lowest alternative to the FSLIC. The Bank Board is informed of the bidders and the terms and conditions of the proposals at various times during the bid process. Upon the identification of the lowest cost bid, the FSLIC staff receives permission to enter into final negotiations with the lowest cost bidder. In most cases, these negotiations ultimately lead to a final sale. In a few instances, final negotiation reached an impasse due to the unacceptability of certain terms and conditions of a specific transaction. In such a case, the FSLIC, upon Board approval, entered into negotiations with the next best bidder.

Question: Does the FSLIC face open-ended liability as a result of guarantees made to acquirors of insolvent institutions as part of the Southwest Plan transactions?

No.

Question: Was the purpose of the Southwest Plan to create an appearance that the problem was being resolved?

No.

To date, the Southwest Plan has achieved significant success in its objective to restore viability in the Texas financial marketplace. Specifically, the Southwest Plan was designed to eliminate branch redundancies. To date 277 out of 835 branches (32%) acquired in Southwest Plan transactions have been closed or scheduled for closing. Specifically, 240 branches have been closed and 37 are scheduled for closing.

The Southwest Plan was designed to reduce operating expenses. Last years' figures from three of the Southwest Plan's consolidations (Southwest SA, Merabank SA and American Federal SA) have shown operating expenses decrease on the average of 41%. Although these savings are somewhat higher due to greater consolidation through market overlaps, all Southwest Plan transactions reduce or eliminate duplications and redundancies in the overall operating costs. For example, the employee base for Southwest Plan institutions has been reduced by 24%. The savings realized through staff reductions as well as the consolidation of branches are approaching $125 million annually.

The Southwest Plan was designed to lower the Texas Premium--the difference between the U.S. average cost of funds and the Texas cost of funds. The Texas Premium has been lowered relative to the national cost of funds for thrifts and the 6-month Treasury rate. In March, 1988, the Texas cost of funds for Texas thrifts was 8.03, the national cost of funds for thrifts was 7.38 and the 6-month Treasury rate was 5.91. By September of 1988, the Texas cost of funds was 8.05, the national cost of funds was 7.51 and the 6-month Treasury rate was 7.43. The Texas cost of funds for the fourth quarter of 1988 was 8.16%, while the national average for the same quarter was 7.71%. Thus, since the Plan began, the differential that the Texas thrifts pay has continually declined in spite of the fact that T-bills have risen (thereby reversing the normal spread relationship between T-bills and the cost of funds).

The lowering of the Texas Premium for deposits has already had a dramatic impact by reducing interest expense in an amount approaching $800 million annually. Since the implementation of the Plan, the Texas cost of funds has been reduced from an average of 75 basis points above the national average in 1987 to an average of 45 basis points above the national average in 1988. Some insolvent Texas thrifts (evenwhile under tight regulatory control) must continue to pay more than the national average to attract deposits to cover operational expenses in the the short-term. However, as the Plan progresses, these institutions will be forced to compete or merged out of existence.

The Plan was also designed to bring in new capital to the thrift industry in Texas. The bidding process was designed to ensure that all suitable bidders (both existing depository institutions and new entrants to the thrift industry) were identified and treated fairly as well as to attract new sources of capital. To date, over $1.1 billion in capital has been infused into Texas by thrift institutions and new entrants into the thrift industry. By contrast, in 1985 (the last year in which Texas institutions reported a positive tangible net worth), the tangible net worth of all Texas thrifts (according to FHLB-Dallas statistics) was only $345 million.

Finally, the Southwest Plan has attracted new ownership and management possessing the ability to create a viable thrift industry in Texas in a deregulated environment. The importance of new ownership and management cannot be underestimated. In response to Congressional reports and constant allegations depicting fraud in the thrift industry, the Southwest Plan has replaced ownerships and managements that had incentives to "cover up" problems with new owners and managers that have legal and economic incentives to uncover fraudulent practices. All Southwest Plan acquirors are directed to report all suspicious activity that they uncover to the relevant authorities. While the Southwest Plan may not expedite the prosecution of the guilty, the implementation of the Plan has and will continue to result in their removal and the discovery of their misdeeds.

The sale of the Southwest Plan Thrift Groups has resulted in the privatization of the asset management and disposition functions. Such a solution lessens the burden placed upon FADA and will ensure a greater return on assets for FSLIC at the event of an economic turnaround. Liquidation of institutions only places more assets in FADA and FSLIC Corporate accounts. The costs attendant to managing these assets as well as the further depression of asset values that result from mass liquidations are avoided by the Southwest Plan. By preventing a downward spiral in asset values, the Plan in effect protects those solvent thrifts and commercial banks from the continued devaluation of their portfolios.

Question: Was there a "two-track" bidding process; one track for individuals with no connection with the Bank Board, and another preferred track for bidders who know Bank Board employees?

Absolutely not.

A review of the acquirors demonstrates that a vast majority of them are new entrants into the thrift industry and therefore could not have been pre-designated as one of the questions suggest. In fact, new potential acquirors had contacted the FSLIC/Southwest Plan staff in the early fall and as late as December and January of this year. Some of these newly identified acquirors were moving toward a successful completion of their transactions when the Plan was put on hold.

The claim of any preferential treatment to those represented by current or former Bank Board employees is unfounded. At the time determinations were made regarding the suitability of bidders, the FSLIC/Southwest Plan staff had little, if any knowledge, of the identity of bidder's representation or connections to the Bank Board. By simply identifying the acquirors of Southwest Plan institutions, one can see that participation in the Plan was independent of "connections". In fact, many unsuccessful bidders hired former Bank Board employees. Therefore, representation by Bank Board officials did not result in preferential treatment.

Lowell Bryan

RESPONSE TO QUESTIONS FROM SENATOR GARN

Q.1. The Bank Board has recently proposed a risk-based capital regulation that would vary minimum required capital levels based on both the credit risk and interest rate risk of a thrift institution's portfolio. Certain assets would require no capital cushion, such as cash or short-term government securities, while other assets would require as much as 18 percent capital, such as direct real estate investments or equity investments. However, even if an institution invested all of its assets in risk-free instruments, it would still be required to maintain a flat 2 percent minimum ratio of capital to total assets. This proposal would be phased-in over several years, would require institutions to increase their capital substantially (or restructure their assets substantially), and is generally regarded as a tough standard. What is your view of the proposal?

As I indicated in my testimony, the fear of losing one's money causes people to weigh risk/return tradeoffs carefully. Therefore, it is imperative to have sufficient private capital at risk and up front to backstop our deposit insurance system.

With the caveat that all capital standards are subjective, I generally support within the present depository system the notion of risk-based capital standards for both credit and interest rate risk. As long as thrifts continue to invest in long term, nonliquid assets, I believe a 2 percent minimum ratio of capital to total assets is too low and would feel more comfortable with a 3 percent minimum floor as recently supported by the Administration and the FDIC.

Q.2. The Southwest Plan transactions have been criticized for resulting in thrifts with too little capital in proportion to total assets. (One figure puts the average at between 2 and 3 percent.) FSLIC's response is based on the risk-based capital proposal described in my first question. Its argument is that most of the assets in a newly-acquired Southwest Plan thrift are a combination of FSLIC notes and FSLIC-guaranteed assets, both of which in effect have short-term interest rates. FSLIC assumes that the government will make good on these commitments, and as a result, they are risk-free assets for the new institution, like cash or U.S. Treasury securities. As such, they require no capital cushion under the Bank Board's new risk-based capital regulatory scheme. The institution must still contribute substantial capital to support the risky assets in its portfolio, and must still meet an overall requirement of two percent capital to total assets even if it is entirely invested in risk-free assets. In addition, any new assets would have to be supported by capital according to the risk-based scheme. According to the Bank Board, virtually all of the new Southwest plan thrifts satisfy the new risk-based capital minimum requirements, with high capital levels in relation to the assets that are actually risky. In short, while the capital-to-total-asset ratio is typically low, the capital-to-risky-asset ratio is typically quite high, and therefore the "moral hazard" to take excessive risks because of low capital levels is simply not present. What is your response?

It is correct that the so-called Southwest Plan deals have been criticized because too little private capital has been invested. Moreover, because FSLIC has not had the cash resources to resolve troubled institutions, the Bank Board has had to resort to the use of notes and guarantees in assisted transactions. In my opinion, the FSLIC notes and guarantees must be honored (or restructured where it makes financial sense for the Government and is permissible under the terms of the assistance agreement) and in fact the Administration's reform package contains funds to honor past commitments.

As I indicated above, however, I believe it is important to have sufficient private capital at risk as a cushion ahead of the deposit insurance fund and the taxpayer. In the Southwest Plan deals, there are still operating risks on both sides of the balance sheet for these institutions and, as we have seen, significant problems can arise between examinations by the federal supervisors.

Based on information publicly available at the time, we estimated that for the 63 merged/acquired thrifts referred to in Exhibit 6 of my testimony post-merger tangible net worth amounted to a negative 6.5 percent of total assets. To achieve a level of tangible net worth equivalent to 2 percent of total assets would have required an additional infusion of about $2.0 billion of private capital; to achieve a level of tangible net worth of 2 percent of "risky" assets (e.g., total assets minus FSLIC promissory notes) would have required an additional $1.9 billion of private capital.

Q.3. You state in your testimony that "an overwhelming advantage of liquidation, however, is that the ultimate maximum costs are know, while under the Southwest Plan approach, the ultimate costs are unknown since all downside risks are absorbed by the government and the incentives to take massive upside risks remain." Isn't it true that in both a liquidation and an assisted merger that the costs are equally uncertain, at least as they relate to non-performing assets?

In a liquidation, the government must pay off all insured depositors, and in return receives the assets of the failed institution. The eventual net cost to the government cannot be determined until all of the assets are disposed of. Meanwhile, the government has costs associated with maintaining these assets. These costs may include, for example, maintaining the condition of an office building, protecting undeveloped real estate, heating, cooling, insurance, security and similar expenses. Thus, the eventual cost to the government cannot really be determined at the time of the liquidation.

In a Southwest Plan acquisition, the new institution retains the bad assets of the insolvent savings and loan. FSLIC guarantees the full value of these assets and provides incentives for these assets to be sold. When they are sold, the government will lose the difference between the asset's book value and its market value, but this loss would be assumed by the government in any case if it liquidated the institution. In addition, the government replaces the lost income from these bad assets through a yield maintenance agreement, which is similar to the carrying costs involved in a liquidation. Thus FSLIC's costs of resolving bad assets in a Southwest Plan merger appear similar, and just about as uncertain as, the cost of resolving these assets in a liquidation.

The big difference between the two resolutions appears to be that in a liquidation, the government must manage and dispose of the assets, while in the Southwest Plan the surviving company has that job. As Mr. Horvitz notes in his testimony, the FDIC has concluded that it is generally more expensive for the insurance fund to dispose of assets than the private sector. In addition, if the institution is mismanaging the assets, FSLIC always has the option of buying them back. Do you agree with this analysis? If so, why do you believe the risk of loss is so much greater to the insurance fund in a Southwest Plan transaction than in a liquidation -- especially when liquidations clearly destroy any franchise value that may exist? It would appear that the loss potential for "covered assets" is roughly similar. As for the other assets, FSLIC maintains that the institutions do have adequate risk-based capital to cushion losses, as described above. Please comment.

As I indicated in my testimony (particularly Exhibit 6), we estimated that the liquidation costs of the 63 "Southwest Plan" thrifts were significantly less than the net present value cost of the rescue of these particular institutions. The potential cost to the Government of a "Southwest Plan" acquisition is significantly higher than that of outright liquidation. The difference is driven mainly by a higher cost of funding (e.g., thrift deposit rate versus Treasury bond rate), continuation of operating expenses and deposit growth that are reflected in an increase in negative net worth, a larger Government exposure to interest rate risk through the yield maintenance agreements, and the loss of potential tax revenues.

I stressed in my statement that not all institutions should be liquidated; some like American Savings and Loan clearly have a franchise value and could be sold to reduce the Government's cost. The magnitude of the undertaking, however, indicates that there is a massive liquidation effort required. Liquidation of an institution does not require that assets be managed or disposed of by the Government. There also undoubtedly will be a major role for the private sector to play in the disposal of assets. I would anticipate that the Government would set the standards, that competitive and responsible private sector bidders would be welcomed, and that there would be incentive clauses to maximize the return to the Government.

Q.4. Do you believe that the separation of FSLIC from the Bank Board is necessary? Please elaborate on this point. Do you believe that the combination of the chartering agency and the insurance agency creates an inherently risky situation? If not, why not? Do you believe that the separation of the two agencies would have short or long term deleterious consequences? If so, please explain.

Yes, I believe that FSLIC and the Bank Board should be separated completely, as the Administration has proposed and the Senate re-affirmed. Combining the chartering and insurance functions led to an unstable system; separating the two functions should contribute to a system of checks and balances on the operations of individual institutions. Whatever negative short-term developments should arise from the administrative separation should be more than offset by the long-term systemic improvements.

Q.5. Occasionally, we have heard criticism of the fact that the supervisory responsibilities of the Bank Board have been shifted to the Federal Home Loan Bank System? Do you believe that this transfer of functions has been beneficial or detrimental? Do you believe a conflict arises due to the fact that the Bank System is member-owned, and thus in effect is policing itself? Isn't it true that the supervision of Federal Reserve member banks is carried out under a similar model? Have they experienced conflict of interest problems?

Conflicts of interest undoubtedly arise from any system that is member-owned and that is held accountable to police itself. General supervisory authority should be centralized and made accountable, so a clear chain of command and responsibility is present.

I do not believe it is correct to state that the current Federal Home Loan Bank and Federal Reserve models are similar. For example, both the boards of directors and the supervisory process are structured differently, with far more centralization in the Federal Reserve System (particularly with regard to the Board of Governors) than exists within the Federal Home Loan Bank System. For these reasons, the Administration has chosen to revamp the Federal Home Loan Bank System along the lines of the Federal Reserve model. I have no personal knowledge of any conflicts of interest under the Federal Reserve System model.

Q.6. You have endorsed market value accounting as an important regulatory tool. Should this apply to all financial institutions? What are the arguments against using market value accounting?

I continue to believe that all financial institutions should use market value accounting where it is appropriate and given a reasonable phase-in period since transition costs could be significant. It is most appropriate to apply market value accounting to marketable securities, but it may not be feasible to mark illiquid assets to market.

Q.7. What recommendations would you make for curbing the use and abuse of state-chartered thrift powers? Should all state powers be cut back to federal powers? Or should the regulators be made to adopt tougher standards that still retain some flexibility to approve innovative state changes that don't pose a threat to the insurance fund?

The Administration has recognized the appropriate balance between the responsibilities of the deposit insurance fund to protect taxpayers and the rights of states to authorize powers for state-chartered savings and loan associations that go beyond those powers conferred by Congress for federal associations. Empowering the FDIC to review, on a case-by-case basis, and possibly restrict those activities that may pose a threat to the insurance fund is far preferable to completely preempting the rights of states to promote financial services that both benefit consumers and promote competition.

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